IN THE

United States Circuit Court of Appeals
In and for the Ninth Circuit

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY
Appellants

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY
Appellees

No. 2813

ANSWERING BRIEF OF APPELLEES, IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver, etc., GUARANTY TRUST COMPANY and ELECTRIC INVESTMENT COMPANY

JOHN F. MAC LANE
Salt Lake City, Utah
Attorney and Solicitor for Appellees Above-Named

HENRY ROOT STERN
New York City, N. Y.
Of Counsel

—*1916*—

United States Circuit Court of Appeals

In and for the Ninth Circuit.

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA AND I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT AND POWER COMPANY, O. G. F. MARKUS, Receiver of said company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL & WIRE COMPANY, GENERAL ELECTRIC COMPANY AND WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees

No. 2813.

ANSWERING BRIEF OF APPELLEES IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, RECEIVER OF SAID COMPANY, GUARANTY TRUST COMPANY, TRUSTEE, AND ELECTRIC INVESTMENT COMPANY.

Preliminary Statement.

The facts are so fully discussed in connection with the subsequent argument that there is little to add at this point, to the statement of the case presented by the appellants in their opening brief and to the concise summary of the proceedings contained in the opinion

of Judge Dietrich, to be found at pages 134 and 135 of the transcript.

We shall, therefore, merely refer to certain isolated facts not mentioned by the appellants which might otherwise escape the attention of the Court.

The mortgage, which was the subject of the foreclosure suit, covered all after acquired property and all income and profits of all of the properties subject to the mortgage (Tr., p. 99).

Nevertheless, the Court below refused to impound for the benefit of the bondholders any of the income received or collections made by the Receiver prior to December 19, 1914, viz.: for a period of about one year after the appointment of the Receiver, and the income and collections of that year were set apart by the Court for distribution among the *general* creditors (Tr., pp. 159, 160). The record does not show what, if any, income was earned by the Receiver subsequent to December, 1914.

The property was sold under foreclosure to the Electric Investment Company for a sum only sufficient to pay to the bondholders a dividend of $534.15 on each thousand dollar bond outstanding, *or only a little over* 53 *per cent.* (Tr., p. 111).

All payments made by the Receiver for the first year of his receivership for interest, sinking fund payments upon underlying mortgages and construction were charged by the Court below against the Trustee and the bondholders represented by it, except interest and construction payments made on account

of the Boise Railroad Company, the properties of which company were held by the Court not to be subject to the mortgage of the Guaranty Trust Company (Tr., pp. 160, 161).

Five creditors intervened, claiming the right to equitable preference for their claims, namely, John A. Roebling Sons Company, I. P. Morris Company (both of which are appellants in this Court), American Steel & Wire Company, General Electric Company and Westinghouse Electric & Manufacturing Company. All of these claims were disallowed as preferred claims, except that in the case of the three claimants last mentioned certain minor items of their claims were so allowed (Tr., pp. 152, 153). Neither the American Steel & Wire Company, the General Electric Company nor the Westinghouse Electric & Manufacturing Company, however, appealed from the decree of the Court disallowing the balance of their claims and, in fact, they refused to join in the said appeal, and accordingly are named as appellees after severance (Tr., pp. 180, 181).

The appellants lay considerable stress upon the allegation in the bill of complaint of the Guaranty Trust Company, referring to the various properties subject to the mortgage and described in detail at pages 95 to 99 of the transcript, reading as follows:

> "That said properties, real and personal, constitute a single, indivisible hydro-electric power system, including stations, sub-stations, transmission and distribution lines, *and* a single indivisible

> electric street and interurban railway system with properties appurtenant to, and used in connection with, said power and railway properties" (Tr., pp. 99, 100).

Appellants apparently construe this allegation as meaning that all of the property subject to the mortgage constituted but *one* system. What the bill of complaint actually alleged, however, was that the properties, when properly grouped, constituted *two* systems—first, a hydro-electric power system and, secondly, an electric street and interurban railway system.

The materials furnished by the claimants were used solely in connection with the power system and consisted, in so far as the appellant Roebling's Sons Company is concerned, in copper wire used principally in the construction of a new transmission line approximately thirty miles in length from the Swan Falls Power Plant of the Railway Company to the pumping plant of an irrigation company, and, the balance in the construction of extensions to the existing irrigation system of another company known as the Idaho-Oregon Light & Power Company.

So far as the appellant I. P. Morris Company is concerned, the material furnished by it consisted in important power machinery required in order to increase the capacity of the Swan Falls Power Plant,

> "and the enlargement and improvement made at the Swan Falls Plant under the Morris contract was for the purpose of putting the Railway Com-

pany in a condition *to better serve its customers* and to supply the *increasing demand* for electric current" (Tr., p. 69).

After the installation of the machinery supplied by the I. P. Morris Company, the latter generated twenty-five forty-seconds, or approximately 60 per cent. of the total capacity of the Swan Falls Plant, which was the only power plant owned and operated directly by the Railway Company (Tr., p. 70).

The stipulation of facts states that the claimant John A. Roebling Sons Company sold and delivered the copper wire in question between the 18th of March and the 30th of May, 1913, but there is nothing in the record to show what items were delivered on any particular day or days during that period. Payment was due "on bills as rendered within thirty days from the delivery of the various items specified," so that nothing could have been due on this claim before April 18, 1913. Prior to the appointment of the Receiver, the defendant company paid to the claimant the sum of $17,519.80 on account, leaving a balance due of $21,057.37 with interest (Tr., pp. 42, 43). There is nothing in the record to show that the claimant applied this payment in satisfaction of any particular part of the account.

With regard to the I. P. Morris claim, for the furnishing and installation of power machinery, the contract was not completed until the latter part of September, 1913. On December 9, 1913, the Railway Company formally accepted the machinery furnished

and work done by the claimant, and thereupon paid the latter the sum of $21,266 and gave its two promissory notes each in the sum of $13,246.58, one due in three months and the other in six months from date. There is nothing in the record to show that any particular application was made by the claimant of the payment in question to any particular portion of the claim. The material was furnished and work performed under a contract between claimant and the defendant company entered into on October 31, 1912, about fourteen months prior to the appointment of the Receiver.

The claim made by the appellants that their debts should receive equitable preference is predicated upon the contention that there was a so-called diversion of income amounting to $115,500 arising from the payment of bond interest by the defendant company on June 1st, 1913, amounting to $165,750.

We have analyzed this contention and the figures on which it is based so fully under Point II (infra), that it will be sufficient at this stage merely to point out that the payment in question, with the exception of about a little over a thousand dollars, was made out of deposit reserves, theretofore, set up by the defendant company from its earnings and from the proceeds of sale of its bonds during December, 1912, January, February, March and April, 1913.

In other words, to the extent that earnings were included at all in the payment of June 1st, they were practically altogether earnings which had been made

by the defendant company prior to the accrual of the claims of either of the claimants and did not include earnings within approximately eight months prior to the appointment of the Receiver.

One further fact is to be noted with respect to the I. P. Morris claim, namely, that, to the extent of $5,138, it consists of an item of extra parts called for by the contract, but never furnished by the claimant either to the Railway Company or to its Receiver (Tr., p. 68). We do not understand that this appellant seriously contends that so much of its claim as consists in the price of the undelivered spare parts is entitled to preference.

The following are the principal questions presented by this appeal:

1.

Was the material furnished by the respective claimants in the nature of current supplies to be used in connection with the ordinary daily operation of the Company, and normally payable out of current earnings, or was it supplied for new construction, extensions or improvements of an extraordinary nature, properly chargeable to capital account?

2.

Was there any diversion of net income earned after the accrual of the claims in suit?

3.

Did the claims accrue within a sufficiently short time prior to the appointment of the receiver so as to justify their inclusion in the preferential class?

Points and Authorities.

1.

NEITHER OF THE CLAIMS IS FOR MATERIAL OR SUPPLIES FURNISHED TO THE COMPANY IN CONNECTION WITH THE CURRENT DAILY OPERATION EITHER OF ITS TROLLEY LINES OR ITS POWER PLANT. ON THE CONTRARY, ONE OF THEM REPRESENTS THE BALANCE OF A DEBT FOR OVER $38,000 FOR COPPER WIRE FURNISHED TO THE DEFENDANT COMPANY, PARTLY FOR THE BENEFIT OF ANOTHER COMPANY, FOR USE IN THE CONSTRUCTION OF A NUMBER OF NEW EXTENSIONS THEN BEING INSTALLED BY THAT OTHER COMPANY, AND PARTLY IN CONNECTION WITH THE CONSTRUCTION OF AN ENTIRELY NEW AND IMPORTANT TRANSMISSION LINE THEN BEING BUILT BY THE DEFENDANT COMPANY; THE OTHER REPRESENTS THE BALANCE OF A DEBT OF OVER $48,000 FOR THE SALE OF MACHINERY WHICH PRODUCES ABOUT 60 PER CENT. OF THE TOTAL CAPACITY OF THE DEFENDANT COMPANY'S POWER PLANT.

Kneeland vs. American Loan Co., 136 U. S., 89;
Porter vs. Pittsburgh Bessemer Steel Co., 120 U. S., 649;
Toledo R. R. Co. vs. Hamilton, 134 U. S., 296;
Wood vs. Guaranty Trust and Safe Deposit Co., 128 U. S., 416;
Southern R. R. Co. vs. Carnegie Steel Co., 176 U. S., 257;

Lackawanna Coal and Iron Co. vs. Farmers' Loan and Trust Co., 176 U. S., 298;
High on Receivers, 4th Ed., Sec. 394-h;
Street on Equity Practice, Vol. 3, Sec. 2750;
Bound vs. South Carolina Ry. Co., 58 Fed., 473;
Reyburn vs. Consumers G. F. and L. Co., 29 Fed., 561;
California S. D. and T. Co. vs. Yakima Inv. Co., 82 Fed., 542;
Doud vs. Illinois Trust and Savings Bank, 105 Fed., 123;
Gregg vs. Metropolitan Trust Co., 197 U. S., 183;
Rhode Island Locomotive Works vs. Continental Trust Co., 108 Fed., 5;
Niles Tool Works vs. Louisville, N. A. and C. Ry Co., 112 Fed., 561;
Rodger Ballast Car Co. vs. Omaha K. C. and E. R. Co., 154 Fed., 629;
Central Trust Co. vs. Colorado Ry. L. and P. Co., 200 Fed., 85;
Love vs. North American Co., 229 Fed., 103;
Atlantic Trust Co. vs. Dana, 128 Fed., 209;
Lee vs. Penn Traction Co., 105 Fed., 405;
Atlantic Trust Co. vs. Woodbridge C. and Ir. Co., 79 Fed., 39;
Spencer vs. Taylor Creek Ditch Co., 194 Fed., 635.

II.

THE CLAIMANTS UTTERLY FAILED TO SUSTAIN THE BURDEN RESTING UPON THEM TO SHOW A DIVERSION OF CURRENT INCOME EARNED BEFORE THE ACCRUAL OF THE DEBTS UPON WHICH THEIR CLAIMS ARE BASED.

> *Gregg vs. Metropolitan Trust Co.,* 197 U. S., 183;
> *Central Trust Co. vs. East Tennessee, V. and G. R. Co.,* 80 Fed., 624;
> *Kansas Loan and Trust Co. vs. Electric R'way, L. and P. Co.,* 108 Fed., 702;
> *Fordyce vs. Omaha, Kansas City and E. R. R. Co.,* 145 Fed., 544;
> *St. Louis, Alton and Terre Haute R. R. Co. vs. C. C. C. and I. R. Co.,* 125 U. S., 658;
> *Lincoln Trust Co. vs. Missouri Water, Light and Traction Co.,* 131 S. W., 889.

III.

CONCEDEDLY THE ROEBLING CLAIM ACCRUED MORE THAN SIX MONTHS PRIOR TO THE APPOINTMENT OF THE RECEIVER. EITHER THE SAME IS TRUE WITH RESPECT TO THE I. P. MORRIS CLAIM, OR THERE WAS NO DIVERSION OF INCOME AFTER THE ACCRUAL OF THAT CLAIM. IN NEITHER CASE IS THERE ANY SPECIAL EQUITY REQUIRING THE COURT TO DISREGARD THE SIX MONTHS' RULE.

> *Thomas vs. Peoria and R. I. R. R. Co.,* 36 Fed., 808;
> *Central Trust Co. vs. E. Tennessee V. and G. R. Co.,* 80 Fed., 624;

Reyburn vs. Consumers G. F. and L. Co., 29 Fed., 561;

Rodger Ballast Car Co. vs. Omaha, K. C. and E. R. Co., 154 Fed., 629;

Moore vs. Donahoo, 217 Fed., 177;

Spencer vs. Taylor Creek Ditch Co., 194 Fed., 635;

Cook on Corporations, 7th Ed., Vol. 4, Sec. 661;

Westinghouse Air Brake Co. vs. Kansas City So. Ry. Co., 137 Fed., 26;

Blair vs. St. Louis R. R. Co., 22 Fed., 471.

ARGUMENT.

I.

Neither of the claims is for material or supplies furnished to the Company in connection with the current daily operation either of its trolley lines or its power plant. On the contrary, one of them represents the balance of a debt for over $38,000 for copper wire furnished to the defendant Company, partly for the benefit of another company, for use in the construction of a number of new extensions then being installed by that other company, and partly in connection with the construction of an entirely new and important transmission line then being built by the defendant Company; the other represents the balance of a debt of over $48,000, for the sale of machinery which produces about 60 per cent. of the total capacity of the defendant Company's power plant.

The question as to when and under what circumstances material and supply claimants may, in railroad foreclosures, be granted priority over the lien of a pre-existing mortgage has been so exhaustively discussed in a long line of decisions of the Supreme Court of the United States and in the various Circuit Courts since the year 1878, when the pioneer case of *Fosdick v. Schall* was decided, that it would not be profitable to review here the variegated history of this doctrine.

The enormous development and expansion of railroad construction and operation throughout this country during the last forty years, and the mass of litigation in federal courts, involving this question has, naturally, brought about many modifications in and limitations of the main principle, which was formulated at a time when the difficulties of applying it to the numerous and diverse claims resulting therefrom were not, perhaps, fully appreciated.

The evils that might flow from a loose application of some of the general expressions contained in the opinion of the Court in *Fosdick v. Schall* were fully apparent to the Supreme Court about ten years later. Clear evidence of this is to be found in the following language of Judge Brewer in the case of *Kneeland v. American Loan Co.,* 136 U. S., 89, at pages 97 and 98:

> "Because in a *few specified and limited cases* this Court has declared that unsecured claims were entitled to priority over mortgage debts, an idea seems to have obtained that a Court appointing a receiver acquires power to give such preference to *any* general and unsecured claims. * * * *Can anything be conceived which more thoroughly destroys the sacredness of contract obligations? One holding a mortgage debt upon a railroad has the same right to demand and expect of the Court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot.* * * * No one is bound to sell to a railroad company or to work for it, and whoever has dealings with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of

subsequently displacing the priority of the mortgage liens. *It is the exception and not the rule that such priority of liens can be displaced.* We emphasize this fact of the sacredness of contract liens, for the reason that there seems to be growing an idea, that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of the displacement of vested liens" (Italics ours).

This language was quoted with approval by the same Court in the later case of *Thomas v. Western Car Company,* 149 U. S., 95, at page 111.

The *character* of the claims which the Supreme Court at that date, and ever since, has had in mind as deserving preferential treatment is illustrated by the following language of Judge Shiras, id. page 112:

"The case of a corporation for the manufacture and sale of cars, dealing with a railroad company, whose road is subject to a mortgage securing outstanding bonds, is very different from that of work-men and employes, *or of those who furnish, from day to day, supplies necessary for the maintenance of the railroad*" (Italics ours).

It had been previously settled by a number of decisions in the Supreme Court that claims for labor or supplies furnished in connection with *construction* work, as distinguished from ordinary *operating* expenses, were not entitled to preferential treatment.

"We are not aware of any well-considered adjudged case, which, in the absence of a statutory provision, holds that unsecured floating debts for *contruction* are a lien on a railroad superior to the lien of a valid mortgage duly recorded, and of

bonds secured thereby and held by *bonafide* purchasers for value. The authorities are all the other way." (Italics ours.)

> *Porter vs. Pittsburg Bessemer Steel Co.,* 120 U. S., 649, at 671; opinion of Blatchford, J.

See also

> *Toledo R. R. Co, vs. Hamilton,* 134 U. S., 296, at page 301, et seq., and
> *Wood vs. Guaranty Trust and Safe Deposit Co.,* 128 U. S., 416,

where Mr. Justice Lamar held, in answer to the contention that a claim for construction was entitled to a preference, at page 421, as follows:

> "The argument is unsound. There are several answers to it. First, it overlooks the vital distinction between a debt for construction, and one for operating expenses. The doctrine of *Fosdick v. Schall* is applicable wholly to the latter class of liabilities. In the case of *Cowdrey v. Galveston Railroad,* 93 U. S., 352, it was settled that the doctrine does not apply where it is a question of original construction. Secondly, it overlooks the important fact that the doctrine only applies where there is a diversion of the income of a 'going concern' from the purpose to which that income is equitably primarily devoted; viz., *the payment of the operating expenses of the concern.* In other words, the income must be first devoted to the *expenses* of producing the income." (Italics ours.)

The foregoing principles were, if possible even

more clearly defined and applied in the two leading cases of *Southern Railway Co. vs. Carnegie Steel Company,* 176 U. S., 257, and *Lackawanna Iron and Coal Co. vs. Farmers' Loan and Trust Co.,* 176 U. S., 298. In the *Southern Railway* case, the Carnegie Steel Company filed a claim for preference for $125,067.49 (id. 272) for steel rails furnished to the Danville Company from time to time. The total mileage of the Danville Railroad, including its auxiliary portions aggregated 3,320 miles (id. 259). The business of the road was so enormous that even during the receivership, the *net* earnings for the period of thirteen months and a half were approximately three million three hundred thousand dollars.

After a full review of all the previous cases in the Supreme Court, Mr. Justice Harlan held as follows, at page 285:

> "But it may be safely affirmed, upon the authority of former decisions, that a railroad mortgagee when accepting his security impliedly agrees that the *current* debts of a railroad company contracted in the *ordinary course of its business* shall be paid out of *current* receipts before he has any claim upon such income; that, within this rule, a debt not contracted upon the personal credit of the company, but to keep the railroad itself in condition to be used *with reasonable safety for the transportation of persons and property,* and with the expectation of the *parties* that it was to be met out of the *current* receipts of the company, may be treated as a current debt; that whether the debt was contracted upon the personal credit of the

company, without any reference to its receipts, is to be determined in each case by the amount of the debt, the time and terms of payment, and all other circumstances attending the transaction." (Italics ours.)

It appeared that after the receivers were appointed, they obtained an order from the court authorizing them to purchase 2,500 tons of new steel rails from the Carnegie Steel Company, on the ground that the financial difficulties of the company during the previous two years had "prevented the operating officers from being able to expend the proper amount for new rails and upon the roadbed and structures, to keep the railroad in the condition in which it should be maintained" (id. 288). The Court below thereupon passed the order authorizing the receivers to make the purchase in order "to properly operate the railroads (in the charge of the receivers) and for the safety of persons and property transported" (id. 228). The Supreme Court held on this point as follows, at pages 288 and 289:

"It is apparent that the purchases of new steel rails while the railroads were in possession of receivers were made in the ordinary course of business and were properly chargeable upon and payable out of current receipts in preference to the claims of mortgage creditors. In every substantial sense the expenses thus incurred were *operating expenses*. * * * Surely the quantity of rails purchased from the Carnegie Company and delivered in 1891 was insignificant in view of the interests involved and the extensive mileage of the

> Danville system, *and was by no means so large as to suggest that they were to be used in constructing new and additional road, and not to keep existing roads in proper condition for use. Every railroad company must have on hand a limited quantity of rails in order to keep every part of its line in proper and safe condition."* (Italics ours.)

And again at page 290:

> *"The quantity of rails was not so large as to preclude the expectation that they could be paid for out of the current earnings of the railroad company. As already said, it was a very small quantity for purposes of ordinary or necessary repairs."* (Italics ours.)

On the same day, the Supreme Court decided the *Lackawanna Iron and Coal Company* case. In that case, the total number of tons of steel rails delivered was approximately 18,600 (id. 304) as against about 4,200 delivered by the Carnegie Steel Company in the case previously decided. The total mileage of the railroad system was approximately 403 miles (id. 298). Although the master found as a fact that,

> "when the aforesaid contracts were made with the said Lackawanna Company *both seller and buyer* expected the debts to be paid from the net income of the railway" (id. 303),

the Court held as follows:

> "The principal ground upon which the Lackawanna Company bases its claim for the relief asked is that when each of the above contracts were made the Waco Division was in such condition that new rails were imperatively required in order

that the road might be safely used for the transportation of persons and property. Such, it may be assumed, was the condition of the road when the rails were contracted for and delivered, for it was so found by the master to whom the intervening petition of the Lackawanna Company was referred with direction to take the account prayed for and to report the facts, and to that report no exceptions were filed. But the necessary inference from the report in connection with the averments of the intervening petition, is that the work required to be done in order to put the main road of the Houston and Texas Central Railway Company and its divisions in proper condition was *not such as would be done in the ordinary course of the business and operations of a railroad,* but was so extensive as to amount to *reconstruction, or the construction of new road.* * * * This Court has uniformly held that in the distribution of the current earnings of an insolvent railroad company, whose property is being administered by a receiver, mortgage creditors could not be postponed to unsecured creditors, unless the debts due the latter were of the class known as *current debts arising in the ordinary course of business and properly chargeable upon current receipts.* The decision in each case has been more or less controlled by its special facts. But we are of opinion that such expenditures as those incurred in the making of the contracts with the Lackawanna Company were not such as are made in the ordinary course of the operations of a railroad, and cannot be deemed *current* debts within the rule that a railroad mortgagee when accepting his security impliedly agrees that the *current* debts of

a railroad company contracted in the ordinary course of its business, in order to keep it a going concern, shall be paid out of *current* receipts before he has any claim upon such income. *Southern Railway Co. v. Carnegie Steel Co.*, ante, 257, and authorities there cited. They are rather to be regarded as *extraordinary expenditures, outside of the ordinary course of business and incurred for purposes not of repair, but of construction.* This Court has said that it is the exception, not the rule, that the priority of mortgage liens can be displaced. *Kneeland v. American Loan and Trust Co.*, 136 U. S., 89, 98; *Thomas v. Western Car Co.*, 149 U. S., 95, 111. We have said that priority of unsecured claims is recognized only in a *few specified cases in which equity and good conscience require that the vested liens of mortgage creditors shall be postponed in the application of current earnings to current debts.* Sound principle forbids that a court of equity should imply an agreement upon the part of mortgage creditors to subordinate their claims to such debts as those due to the Lackawanna Company. *To so hold would place their rights at the mercy of the railroad company having charge of the property upon which their recorded liens rest*" (id., pp, 314, 315 and 316). (Italics ours.)

It is true that the opinion refers to the fact that the rails had been delivered over a long period before the appointment of the receiver, and that the Lackawanna Company had received collateral security for a part of its claim, but these were mentioned as merely *additional* reasons why the claimant was not entitled to a preference, and without in any manner

detracting from the main ground of the decision hereinbefore quoted.

That the doctrine of equitable preference has been clearly limited by the more recent decisions of the Federal courts to claims for supplies furnished in connection with the current operation of the road in the ordinary course of business and does not include claims for extraordinary expenses or improvements or for construction work, is fully recognized by the leading text-book writers on this subject. For instance, High on Receivers, 4th Ed., after criticising the principle of the main doctrine itself, from the point of view of strict logic (Sec. 394-a, p. 503) expresses the particular limitation thereon, which we are now discussing, in the following language:

> "Sec. 394-h. Claims of general creditors other than for operating expenses not preferred. Claims of general creditors of a railway company, which have been incurred prior to the receivership, and which do not fall within the class of current expenses for the ordinary operation and maintenance of the road, such as necessary labor, supplies, materials or equipment, and which do not, therefore, have any special equities entitling them to payment out of current income, will not be preferred out of the earnings of the receiver, or out of the proceeds of the foreclosure sale. The allowance of claims, which results in the displacement of the priority of mortgage liens, is to be regarded as the exception and not as the rule, and such claims will not be given a preference unless they may fairly and reasonably be regarded as debts in-

curred in the *ordinary, daily operation* and maintenance of the road. And where the expense is an extraordinary one, incurred outside the ordinary course of the business of the road, such as for original construction or reconstruction, or for *extraordinary repairs,* or for *extensions or permanent improvements,* the preference will not be granted. And while, from the illustrations given in the preceding sections, where preferences have been given, it will be seen that the courts have, in particular instances, gone to unwarranted extremes in the recognition of such claims, the *decided tendency at the present time,* as shown by the recent cases, is to *restrict* rather than to extend the allowance" (pp. 524, 525). (Italics ours.)

Thereafter, and at pages 525, 526, 527 and 528, the author proceeds to recite case after case, wherein claims for preference were made, in many of which the equity of the claimants greatly exceeded the alleged equities of the claimants in the case at bar, but where nevertheless a preference was uniformly denied.

Street, in his interesting and authoritative work on Federal Equity Practice, Vol. 3, Sec. 2750, page 1585, after discussing the origin and development of the main doctrine, expresses the same views in the following language:

"Sec. 2750. Late limitation on doctrine of earlier cases. The doctrine of these cases has had extensive application in the Federal courts during the last quarter of a century. From time to time the Supreme Court has taken occasion to say that the power thus recognized should be sparingly used; and finally this Court has been impelled to *recon-*

sider its previous utterances and to *limit* the doctrine strictly to those situations where the claim is at its inception *a proper charge against the current account* and where the current income is sufficient to pay such claim or where money has been diverted from that fund." (Italics ours) (p. 1585.)

And again at Sec. 2751, as follows:

> "SEC. 2751. NO PREFERENCE OF BACK DEBT UNLESS CHARGEABLE AGAINST CURRENT ACCOUNT. The most important point to be here borne in mind is found in the proposition that a claim created prior to the receivership can never be given preference unless it arises in immediate connection with the *operation and conduct of the business and is of such nature as to be chargeable to the current account.* No expenditure is considered of this nature where it is made for purposes of making *permanent additions or improvements* to the property or where it is of an *unusual* or *extraordinary* character and not chargeable to the current account. *Even equipment, if supplied in an unusual quantity or under conditions not absolutely requiring it, is not chargeable to the current income, and hence cannot be preferred*" (p. 1588). (Italics ours.)

In the light of the foregoing authorities, let us now analyze the record in the case at bar, in order to determine whether or not the claims of John A. Roebling's Sons Company and I. P. Morris Company, can properly be characterized as debts incurred in the ordinary course of business, and in connection with the day to day operation of the defendant company, and, therefore, properly chargeable to current operating

expense, or whether they are not rather debts incurred in connection with new construction, extensions and extraordinary improvements which could only be properly charged to capital account.

A.

The Nature and Purpose of Material Furnished by John A. Roebling's Sons Company.

The following facts appear from the record: That the material furnished by this claimant consisted of approximately ninety miles of copper cable (Tr. 119) for transmitting power, of the value of $38,-577.17 (Tr. 33). That at the time this material was furnished, the Railway Company was engaged in the construction of a new transmission line, approximating thirty miles in length, from its central station at Swan Falls to a pumping plant of the Gem irrigation district, together with a branch extension, four miles in length, from about the middle of the main transmission line to a station known as the "Guffey" pumping station; prior to that time there had been no transmission line between these points (Tr. 44). That the line was constructed directly from the central station to the new points of use, and did not branch from any pre-existing lines (Tr. 45). That this new line was being built for the purpose of serving irrigation customers with whom contracts had been made by *another* company known as the Idaho-Oregon Light and Power Company, in whose stock the defendant company owned the controlling interest. That in order to fulfill its contracts,

the *Idaho-Oregon* Company was then building *extensions* from its existing system to various points of from one to five or six miles in length, and the defendant company was furnishing material to the Ihado-Oregon Company under an agreement termed an "Equipment Trust" (Tr. 46).

The exact uses to which all of the copper wire was put are set forth in the transcript of the record at pages 46 to 49, and therefore need not be repeated in detail. They are tersely summarized in the opinion of Judge Dietrich as follows:

> "As disclosed by the stipulation, wire to the amount of $91.82 was used for the Swan Falls construction, $26,817.56 for the new Gem and Guffey transmission lines, $1,121.15 for service lines at Eagle, and $10,546.64 for the Idaho-Oregon Light and Power Company" (Tr. 138).

The defendant company owned altogether in the neighborhood of something over 100 miles of transmission lines in all (Tr. 120). By transmission lines, of course, is meant lines for the transmission of power as distinguished from lines used for trolley purposes. The wire used for transmission purpose is not serviceable for trolley purposes (Tr. 121). According to the testimony of Mr. Markus, the manager of the Railway Company and subsequently the receiver, who was called as a witness by trial counsel for the claimants, the construction of the Gem line and branch extension for which the I. P. Morris Company copper cable was used, must have represented an addition of at least thirty per cent.

to the total transmission line owned by the defendant company. Mr. Markhus stated that the Roebling Company furnished ninety miles of cable, and as the proportion of cable to mileage was generally three to one, it is apparent that the claimants furnished enough copper wire to construct this thirty miles of new transmission line. Outside of wire used in construction of the new Gem line the balance of the material furnished represented wire supplied by the defendant company to the Idaho-Oregon Company to construct *new and additional* service extensions by that company. As above stated, this material was furnished under an Equipment Trust agreement, whereby the Railway Company reserved title to the supplies and material furnished until paid for (Tr. 46).

There remains but one item of any, but trifling importance, and that is 40,440-Q for $1,121.15 (Tr. 48). The stipulation of facts states this material was furnished "for use in connection with general service extensions of the Railway Company and its distributing system in and around the unincorporated village of Eagle in Ada County, Idaho." It is to be presumed from the words "service extensions" that the defendant company was at the time engaged in new construction and extending its service to that village. Under any circumstances, however, the burden of proof was upon the claimants to establish that this was an operating expense, and, therefore, we assume that the finding of Judge Dietrich that

> "While the precise nature of the extension work at Eagle is not fully disclosed, it is thought that the facts shown are insufficient to warrant a finding that this item of $1,121.15 was an operating expense" (Tr. 139).

will be regarded by this Court as conclusive.

To summarize the Roebling claim, therefore, it appears that the great bulk of it is for copper cable or wire, by means of which the defendant was enabled to construct an entirely *new* transmission line, representing a great *increase* in its transmission line mileage, into an entirely *new* territory. The balance represented material not used at all in its own business but furnished to *another* company. With regard to the latter, the language used by Judge Dietrich in rejecting the similar claim for preference of the American Steel and Wire Company and to be found at page 141 of the transcript of the record, is pertinent:

> "Preference for that which went to the *Idaho-Oregon* Company must be denied because it in no wise constituted an operating expense of the *Railway* Company, or a current debt contracted in the ordinary course of the business of that company. Surely the loaning of its credit to the Idaho-Oregon Company *was not in the ordinary course of the business of the Railway Company.* The fact that it owned most of the stock of that company and some of its bonds is not controlling. *The stock may have been wholly worthless,* and hence no substantial part of the security of the Railway bondholders, and its interest in the bonds may have been relatively unimportant. The case of *Southern Railway*

Co. v. Carnegie Steel Co., 176 U. S., 257, relied upon with apparent confidence by the claimant, is readily distinguishable, as is made manifest by this simple sentence quoted from the opinion: 'The rights of the Carnegie Company, the claimant, are none the less because the Danville Company (the purchaser) chose, after obtaining the rails, to use a part of them on roads under its control and in its possession, and whose preservation in proper condition was vital to its successful operation.' If we assume that because it was the dominant stockholder the Railway Company had possession of and controlled the property of the Idaho-Oregon Company, it would be going far beyond the facts to say that the maintenance of the Idaho-Oregon plant in proper condition was vital to the successful operation of the Railway Company's system or any part thereof. While the relations of the two systems were such that there were common and mutual interests, the accruing benefits from the use of this material are too remote and contingent to serve as a basis for the application of the rule invoked." (pp. 141, 142.)

That the stock of the Idaho-Oregon Company is worthless, as above suggested by Judge Dietrich, may be assumed from the fact that that Company, too, went into the hands of a receiver (Tr. 145). See also testimony of Mr. Fuller to the effect that the syndicate regarded its investment in the Idaho-Oregon property "of very questionable value, and we as a syndicate, determined to wipe it off" (Tr., p. 132).

Judge Dietrich might well have cited to sustain his reasoning the case of *Southern Ry. Co. v. Ensign Mfg.*

Co., 117 Fed., 417, decided by the Circuit Court of Appeals, Fourth Circuit. The opinion of the court in that case is well worth reading on the whole question of equitable preferences of material and supply claims (see pp. 420, 421). The importance of the case as bearing upon the "equipment trust" question, however, is illustrated by the concluding sentence in the opinion (id., p. 424):

> "Although the contract was made with the Richmond & Danville Railroad Company (the mortgagor company), and the Ensign Manufacturing Company (the claimant) is a creditor thereunder, against this company, yet, as the goods were purchased for and were used by another company, no equity exists, as against the mortgagees of the Richmond & Danville, giving the claim priority over them."

Furthermore, even if we assume (in direct opposition to the finding of the learned judge who had charge of and was thoroughly familiar with every phase of this entire situation) that the defendant company and the Idaho-Oregon Power Company were practically one and the same, nevertheless, the claimant's position is not improved. This is true because it is apparent that this wire was used even by the *Idaho-Oregon Company* not for *repair* or *operating* purposes of any kind, but in connection with the *construction* by the latter company of a number of *new* extensions. (Tr. 46) for the purpose of *increasing* the scope of its business, and was not essential or necessary in order to *preserve* or keep intact the business which it had been conducting *prior* to that time.

The general character of the debt of the claimants cannot be better described than in the following language of Judge Dietrich:

> "*But surely there is no semblance of reason for holding that the extension of a long transmission line into a new territory and the installation of a new distributing system where there has been none before constitute expenses of operation.*" (Tr., 139.)

But this appellant will urge upon the court, as it did below, certain general language in the stipulation of facts in order to supply, if possible, this manifest deficiency in its case.

It is true that the solicitor for the receiver stipulated in the court below that the intervener sold said materials "in the belief and in the intention, *on the intervener's part,* that the same should be paid out of the current operating income" (Tr. 43).

It is to be noted, however, that the intention stipulated was solely that of the *intervener*—there is nothing in the record to justify either a finding of fact or even a *belief* that the *Railway Company* had any such intention. There is no proof to show that the debt was charged by the *railway company* to operating expense, although Mr. Markhus, the manager of the railway company, and subsequently the receiver, was placed upon the stand by the claimants. Evidently he was regarded by them as an impartial witness, to say the least, not only because they called him, but also because the stipulation of facts was based upon data fur-

nished by him (Tr. 115). The claimants had every opportunity to question this witness as to his intention with respect to the payment of these claims, but they did not see fit to do so. Under the circumstances, it must be presumed that if such a question had been put, the answer would have been unfavorable to them.

On the other hand, Mr. Markhus *did* testify that the occasion for placing the Roebling order was the "building and early completion of the Swan Falls-Gem transmission lines" (Tr., 117), and also that the dealings of the company were directly with the representative of the Roebling Company, and "he, no doubt, was made acquainted with where the wire was going and the purpose for which it was to be used in the construction of the Swan Falls-Gem District extension" (Tr., 119).

Assuming, however, what is difficult to believe, that the Roebling Company, although familiar with the purposes for which the purchased material was to be used, nevertheless believed and intended that the same should be paid for out of current operating income, the absence of any proof that such was also the intention of the *purchaser,* is fatal to the claimant's right for equitable preference:

This very court has recently held:

> "The real basis upon which the preference rests is thought to be the implied understanding on the part of *all* parties that such debts are to be paid out of the current income before the mortgagee has any claim thereto."

> *Moore v. Donahoo,* 217 Fed. (9th C.) 177 at 184. (Italics ours.)

To the same effect see *Southern Railway Company v. Carnegie Steel Company,* 176 U. S., at page 290, where the court uses the following language:

> "We next inquire whether it was not at the time the expectation of *both* parties, *vendor* and *vendee,* that the rails delivered by the Carnegie Company between July 25, 1891 and October 10, 1891, should be paid for out of the current earnings of the railroad company." (Italics ours.)

Counsel for the claimants, however, has also seized upon the sentence at the end of the stipulation (Tr., 49) to the effect that:

> "said material is and was necessary to the continued maintenance and operation of the respective parts of said property for which the same was supplied, and in which it is used."

As to this, it is a sufficient answer to quote from the language of Judge Dietrich in his opinion below:

> "It is this last clause, namely, 'and said material is and was necessary,' etc., upon which the intervener relies. But even when taken alone this language does not signify that the wire was used for the purpose of repair or replacement, or that it was necessary to keep the plant a going concern. It is, of course necessary to the maintenance and operation of *those new parts of the system for the construction of which it was used, and that is all.* Any other view would be directly in the face of the concrete facts disclosed by other parts of the stipulation. The material so far as used by the Railway

> Company was employed not in repairing its existing system, but in *enlarging it*. Clearly such expenses are chargeable *not* to operation or maintenance, but to *construction*" (Tr. 138, 139). (Italics ours.)

We might also call attention to the fact that it was only stipulated that the material was necessary to the continued maintenance and operative of the respective parts of the property *"for which the same WAS supplied, or in which it IS used."*

The material *was* supplied for the construction of an entirely *new* and important addition to the defendant company's power properties. It *is* used solely in connection with that self-same addition. Counsel for the appellants in his summary at the end of his brief says that it is admitted by the agreed statement or by the uncontradicted evidence that

> "the material and supplies *were* necessary to the continued maintenance and operation of the Railway Company's property."

If he means the court to understand that it is admitted or has been proved that without the material in question the Railway Company could not have continued to operate, we differ with him. Of course, the material furnished was necessary to the maintenance and operation of the new Swan-Falls-Gem District line, because without it or similar material that line could not have been built. But the line was an entirely *new* line.

There is, of course, nothing in the record to show that the defendant company's business which it had

been conducting prior to this new construction work, could not have been fully maintained and operated without the use of one single *foot* of the wire furnished by the claimant.

B.

The Nature and Purpose of Material Furnished by I. P. Morris Company.

In the Fall of 1912 and prior to October 31st, of that year, the Railway Company determined "to *improve, enlarge* and in part *rebuild*" the Swan Falls power plant, by removing three 300 K. W. generating units and replacing same by two 1250 K. W. generating units, with the necessary foundation, wheel pits, gates and tail races, all so arranged and placed that two additional 1250 K. W. could be installed in the future (Tr., 68).

The Railway Company accordingly entered into an elaborate contract on October 31st, with the I. P. Morris Company for the designing, construction, delivery and installation of the machinery necessary to so enlarge and reconstruct the Swan Falls plant, at a total cost, including extras, of $48,335.37. The main items of the machinery were to be delivered in installments covering a period extending up to April 1st, 1913, and the spare parts were to be delivered within one year from the date of the contract, subject to prior delivery upon three months' notice (Tr., p. 77). The contract also provided for tests of operation after installation (Tr., p. 84), and for rejection if the machinery failed to develop a certain specified efficiency (Tr., p. 79).

The contractor agreed to furnish an Erecting Superintendent, who was to arrive at the purchaser's powerhouse simultaneously with the arrival of the first main unit and was to remain there, at an expense to the purchaser of $10 a day plus all traveling and living expenses, to superintend the erection of all of the machinery to be furnished by the contractor, which necessarily under the terms of the contract would cover a period of several months (Tr., p. 83).

It was stipulated that "*the enlargement and improvement* made at the Swan Falls plant under the Morris contract was for the purpose of putting the Railway Company in a condition to *better* serve its customers and to supply the *increasing* demand for electric current." (Tr., p. 69.) By putting together the stipulation in respect to the Roebling claim and the stipulation in respect to the Morris claim it is apparent that the machinery which the I. P. Morris Company was to furnish was purchased for the purpose of generating the necessary increased power required to be transmitted over the thirty mile new transmission line for which the Roebling Company was supplying copper cable. (See Tr., pp. 44 and 45.) We quote from the latter page as follows:

> "That this line (the new Gem transmission line), then under construction, was constructed from the Swan Falls station for the purpose of serving irrigation customers with whom contracts had been made having a present estimated demand of about 2,000 H. P. and an ultimate estimated demand of about 6,000 H. P. *That these contracts were made*

with a view to utilizing the increased capacity of the Swan Falls central station as thus enlarged."

The capacity of the aforesaid three generating units of the Swan Falls power plant prior to its reconstruction was only 900 K. W. The capacity of the two new generating units supplied by the I. P. Morris Company was 2500 K. W. (Tr., p. 68) and in addition the Morris Company supplied the necessary foundation, wheel pits, gates and tail races, so arranged that two additional 1250 K. W. generating units could be installed in the future (Tr., p. 68). Thus there was an immediate increase in the generating capacity of the plant of 1600 K. W. The total rate reliable capacity of the Swan Falls plant is 4200 K. W., of which 2500 K. W., is generated by the Morris machinery.

In other words, the machinery furnished by the I. P. Morris Company and for which it claims a preference on the ground that its debt is merely one for ordinary operating expense, generates 60 *per cent. of the entire power of the Swan Falls plant, which is the only power plant owned and operated directly by the defendant company* (Tr., p. 70).

If under such circumstances the I. P. Morris claim can be characterized as an ordinary daily operating expense then we can hardly conceive of a claim for *any* kind of material furnished to a railroad company for any purpose whatsoever which might not be deemed to come within the same category.

The material was not even for *replacement* purposes. The substituted units represented an increase in capacity of approximately 177 per cent. over the total ca-

pacity of the units displaced and when installed produced 60 per cent. of the entire power of the plant as a whole.

But this appellant will also urge upon the Court that portion of the stipulation of facts which states that "such machinery *is* necessary to the continued operation of the Railway Company's system and that without it it *could* not perform its duties to the public." (Tr., p. 72.) It is to be noted that the stipulation does not state that such machinery *prior* to its installation was necessary to the continued operation of the system or that without it could not *then* have performed its duties to the public. Of course, such machinery once installed is *now* necessary to the continued operation of the power system of which it has become an integral part, but there is not a word in the record to justify even the supposition that it *was* necessary *prior* to such installation.

Furthermore there is no proof that the machinery in operation prior to the installation of the Morris machinery, was in any way defective or out of repair or that the defendant company could not have gone right along supplying its customers as it had before. It *does* appear, however, that the defendant company was desirous of *enlarging* its capacity and its scope of service, obviously with the purpose of *increasing* its revenue.

Surely, however, this is work of *new* construction, the expense of which is properly chargeable only to capital account.

To maintain that such enlargements are a part of ordinary *operating* expense is contrary to all business experience and common sense.

There is a further clause in the stipulation to the effect "that said material was furnished and work performed by Morris for the Railway Company in the belief and intention that the same, *unless otherwise provided for by the Railway Company* would be paid for out of the operating or current income thereof." (Tr. pp. 72 and 73.)

The qualifying clause "unless otherwise provided for" of course renders this part of the stipulation nugatory so far as the claimant is concerned.

Indeed it actually suggests that the claimant expected that payment *would* be otherwise provided for by the Railway Company.

We also desire to call attention to the fact that the contract for the construction and installation of this machinery was entered into approximately *fourteen months* prior to the appointment of the Receiver; that under its terms the final balance of the purchase price was not to be paid until one hundred and twenty days after the receipt of the apparatus at destination (Tr., p. 87), that the work was not finally completed until the latter part of September, 1913, eleven months after the making of the contract, and was not formally accepted by the defendant company until December 9th, 1913 (Tr., p. 69); that on the date last mentioned the Railway Company paid to the claimant $21,200.66 and gave two promissory notes

each for the sum of $13,246.58, for the balance, one due in three months and the other in six months after said date.

Under these circumstances it is not surprising that Judge Dietrich in the Court below expressed himself upon this aspect of the claimant's case in the following forceful language:

> "In view of all these conditions, it is quite incredible that this claimant or any of the claimants having knowledge of the plans of the Railway Company could have expected that this entire expense would be taken care of out of current receipts." (Transcript, pp. 144 and 145.)

See also

> *Bound v. South Carolina Ry Co.,* (C. C. A.) 58 Fed. 473, at p. 480.

What are Current Expenses of Operation as Defined by the Decisions of the Various District, Circuit and Circuit Courts of Appeal?

We have heretofore discussed the geenral principle developed by the decisions of the Supreme Court of the United States to the effect that only debts which may be properly qualified as current operating expenses may be treated as preferential. An analysis of the decisions of the various district circuit and circuit courts of appeals construing the opinions of the United States Supreme Court and applying them to the claims immediately before them, will demonstrate beyond ques-

tion that the claims before this court are wholly outside of the favored class.

One of the earliest cases is *Reyburn v. Consumers' Gas, Fuel & Light Company*, 29 Fed. 561, decided in 1887. There the claimant intervened in a foreclosure suit against an insolvent gas company, and contended this his claim for gas meters furnished to the company was entitled to a preference. It seems to have been conceded that income had been diverted by the receiver to the improvement and extension of the works and plants of the company. The opinion of Judge Blodgett, in denying the preference, is directly in point on the question of what is operating expense and what is construction. He held as follows:

> "I do not concur with the learned counsel who appeared for this creditor in their position that the goods furnished come under the definition of 'operating supplies.' The debt was wholly contracted for gas-meters, which were a part of the gas-works of the company, and as much required for the complete and operative construction of the works as any other part of the plant or machinery of the works. It is impossible, as the proof shows, for the gas company to sell gas without meters, with which to measure and distribute it to their customers, and from which the accounts are to be made up and the bills collected. It seems to me that it requires meters to make the works of a gas company complete, as much as pipes and generators, and no gasworks can be said to be in operating condition unless they have an adequate supply of meters. The claim, therefore, comes within the definition of a claim for material furnished for the construction of

the works; and from the decision of the Supreme Court of the United States in *Fosdick v. Schall,* 99 U. S. 235, down to the present time, I have seen no case which contemplates, except under very peculiar circumstances, that general creditors who have furnished mere material for the *construction* of works of this character are to have a lien, as against the lien of mortgages. The doctrine of *Fosdick v. Schall,* and the subsequent cases on the same question, is that, for the purpose of keeping works of a public character in operation, those who have given the company credit for the supplies necessary to keep the works in operation—current operating supplies—*are to have a lien extending back not to exceed six months, except under extraordinary circumstances;* but I do not understand that this rule has ever been applied to cases of creditors who have simply furnished material for the construction of the works, in contradistinction to operating material. *The material for the building or construction of the works, in theory, at least, is supposed to be paid for out of the capital stock, or bonds secured by the mortgage upon the property."* Id. 563, 564. (Italics ours.)

If a claim founded upon a sale of gas meters to a gas company cannot properly be considered a part of the current operating expense of that company, how can a claim for ninety miles of copper cable furnished for the construction of a new transmission line, or a claim for valuable and important machinery used in the reconstruction of an electric power plant and representing 60 per cent. of its total generating power be possibly considered as current operating expense?

In *California Safe Deposit & Trust Co. vs. Yakima Inv. Co.,* 82 Fed. 542, the question was fully considered by Judge Hanford, sitting in this Circuit. The claim before the court in that case was for services in the construction of lateral ditches extended from time to time, as required in the actual operation of conducting water to the different tracts of land to be irrigated by an irrigation company. Judge Hanford held as follows:

> "The services of the petitioner Owens, for which compensation is due, were all performed in the original construction of the defendant's irrigating works. In the case of McLean, only a trifling amount of $2.20 of his claim is for labor performed in work that may be denominated operation. *An attempt was made by counsel, in the argument, to make a distinction between the construction of lateral ditches from the main canals, on the ground that the laterals are extended from time to time, as required in the actual operation of conducting water to the tracts to be irrigated.* But in the light of the authorities I must hold that the difference is not sufficient to distinguish the case from other cases in which the general rule has been limited in its application so as to *exclude debts for the cost of original construction.* In the case of *Railroad Co. v. Hamilton,* 134 U. S. 296-306, 10 Sup. Ct. 546, 547, the supreme court of the United States, in its opinion by Mr. Justice Brewer, held emphatically that: "A recorded mortgage, given by a railroad company on its roadbed and other property, creates a lien, whose priority cannot be displaced thereafter

directly by a mortgage given by the company, nor indirectly by a contract between the company and a third party for the erection of buildings or other works of original construction.' The facts of that case afford ground for contending with quite as much reason as in the case now under consideration that the labor for which compensation was claimed should be classed as work necessary in operation, *but in the opinion of the court words seem to have been carefully selected to include all structures and additions made after the road had been put in operation in the same category as the original main line of railway,* and the broad rule laid down in the sentence above quoted is just as applicable to this case as to the one in which the decision was made. I rest my decision upon the authority of that case." Id. 544, 545. (Italics ours.)

If the claimant argues that the construction of the Gem transmission line and the building by the *Idaho-Oregon* Company of additional extensions and the increase in the capacity of the power plant were merely *incidental* to pre-existing operations of the defendant company and the Idaho-Oregon Company respectively, the language of Judge Hanford above italicized is particularly pertinent in refutation of that argument.

In no one of the circuits has the question of the practical application of the rule to be adduced from the decisions of the Supreme Court received greater attention than in the Eighth. The leading case in that circuit is *Doud v. Illinois Trust and Savings Bank,* 105 Fed. 123, which it is to be noted, was decided before *Gregg v. Metropolitan Trust Company,* 197 U.

S. 183, which is the last important decision of the Supreme Court on the general question of equitable preference, and which so plainly evidences the modern tendency of that court to restrict the doctrine in question.

In the *Doud* case the intervener made a loan to an electric light company to construct an addition to its power plant so that its available power would be raised from 600 to 1000 horse power. He claimed a preference on the ground that the construction was necessary to keep the railway company a going concern.

The same question was raised which is raised here, as to whether or not the expense of constructing the additional power plant involving the purchase of new machinery at an expense of $19,000, and which increased the available power of the plant 66-2/3 per cent. could be held a current operating expense incurred in the ordinary course of business. The court answered the question emphatically in the negative and held that the work for which the money was loaned was a work of *construction and enlargement* and *not* a work of operation.

The Court then considered the question as to whether claims arising out of the carrying on of work of *construction* were entitled to a lien on the mortgaged property, and its income superior to that of the prior mortgagee. In order to answer that question Judge Sandborn reviewed fully all of the important decisions of the Supreme Court of the United States which had been decided up to that time, including the cases of *Southern Railway Company v. Carnegie Steel Co.*,

176 U. S. 257, and *Lackawanna Coal and Iron Company vs. Farmers Loan and Trust Company,* 176 U. S., 298, and then held as follows:

> "The authorities to which we have now adverted establish the propositions that a claim for money borrowed or for service rendered or material furnished to construct a *necessary, permanent, and beneficial improvement or addition* to the mortgaged property of a quasi public corporation is *not* entitled in equity to a preference in payment out of the mortgaged property or income over the claims of the bondholders secured by the lien of the prior mortgage, in the face of which the claim accrued; and that neither the fact that the consideration of the claim conserved the property, increased the security of the mortgagee, and rendered the operation of the property more economical, *nor the fact that it was necessary to keep the mortgagor a going concern,* nor the fact that the mortgagor pledged or mortgaged the current income to secure the payment of the claim; can raise such an equity as will entitle it to a preferential lien upon either the income or the corpus of the mortgaged estate over the lien of the prior mortgage. These propositions conclusively answer the question presented in this case." Id. 142-143. (Italics ours.)

The court then referred to the fact that as usual in cases of claims for preferential liens in equity, the case of *Fosdick vs. Schall* (supra) had been cited, quoted, and made the foundation for the argument for the intervener. After quoting from the opinion of Chief Justice Waite in that case, Judge Sandborn held as follows:

"But it is an interesting fact that these remarks upon which so many arguments are based for the preference of unsecured to secured creditors in the application of the income and proceeds of mortgaged property, were obiter dicta, *and that the supreme court has ever since they were delivered been industriously engaged in limiting their terms and restricting their effect,* until it has finally declared in the cases of ***Southern R. Co. v. Carnegie Steel Co.,*** and *Lackawanna Iron and Coal Co. v. Farmers Loan and Trust Co.,* supra, *that no claim which is not a current debt incurred in the ordinary course of the operation of the property of the mortgagor can be allowed a preference in payment over the lien of the prior mortgage.*" Id. 143. (Italics ours.)

Finally the court laid down its fundamental deductions from an exhaustive examination and analysis of all of the previous cases upon the subject of preferential claims in the following clear and authoritative language, which has since been the subject of so much quotation in later decisions:

"When a careful examination and analysis of the facts and opinions in all the cases in the supreme court upon the subject of preferential claims in suits to foreclose mortgages of quasi public corporations is made, and dicta are distinguished from adjudications, the decisions of that court will be found to sustain these propositions: A mortgagee of the property, acquired and to be acquired, and of the income of a quasi public corporation, such as a railroad company, obtains a lien upon the net income of the company after the current expenses of operation incurred in the ordinary course of busi-

ness are paid, and impliedly agrees that the gross income shall be first applied to the payment of these current expenses, before the net income to which he is entitled arises. A court of equity engaged in administering mortgaged railroad property under a receivership in a foreclosure suit may prefer unpaid claims for *current* expenses of the ordinary operation of the railroad, incurred within a *limited* time before the receivership, to a prior mortgage lien, in the distribution of the income or of the proceeds of the mortgaged property. If such a mortgagor diverts the *current* income from the payment of *current* expenses to the payment of interest on the mortgage debt, or to the improvement of the mortgaged property, so that current expenses remain unpaid when a receiver is appointed, the Court may, out of the income accruing during the receivership, restore to the unpaid claims for current expenses the amount so diverted. But if there has been no diversion there can be no restoration, and the amount of the restoration cannot exceed the amount of the diversion. The class of claims which may be awarded a preference in payment over the prior mortgage debt in equity *is limited to claims for current expenses incurred in the ordinary course of the operation of the mortgaged property within a limited time before the appointment of a receiver.* It does not include claims for money loaned, *or for material or labor furnished to make necessary beneficial and permanent additions or improvements to the mortgaged property.* The broad language of the dicta in ***Fosdick vs. Schall,*** that 'necessary operating and managing expenses, proper equipment, and useful improvements' are to be deducted from the current income before the net income out of

which the mortgage debt is to be paid arises, has been disapproved and modified, and the class of claims entitled to equitable preference has been limited, by the later decisions of the Supreme Court in *Kneeland v. Trust Co.,* 136 U. S., 89, 98, 10 Sup. Ct., 950, 34 L. Ed., 379; *Morgan's L. and T. R. and S. S. Co. v. Texas Cent. Ry. Co.,* 137 U. S., 171, 196, 198, 11 Sup. Ct., 71, 34 L. Ed., 625; *Thompson v. Railroad Co.,* 132 U. S., 68, 71, 73, 10 Sup. Ct., 29, 33 L. Ed., 256; *Thomas v. Car Co.,* 149 U. S., 95, 110, 13 Sup. Ct., 824, 37 L. Ed., 663; *Southern R. Co. v. Carnegie Steel Co.,* 176 U. S., 257, 296, 20 Sup. Ct., 347, 44 L. Ed., 458; and *Lackawanna Iron and Coal Co. v. Farmers' Loan and Trust Co.,* 176 U. S., 298, 315, 20 Sup. Ct., 363, 44 L. Ed., 475—*to claims incurred for the current expenses of the operation of the mortgaged property in the ordinary course of the business of the mortgagor. The test of the preferential equity of a claim is its consideration.* If its consideration was a current expense of the operation of the mortgaged property, which inured to its benefit, and which was incurred in the ordinary course of its business, within a limited time anterior to the appointment of the receiver, the claim may be preferred. * * * *If the consideration of a claim is not a part of the current expenses of the ordinary operation of the mortgaged property, but is a part of the expenses of constructing a permanent addition or improvement to it, out of the ordinary course of its operation, neither the fact that it tended to conserve and improve the property and increase the security of the mortgagee, nor the fact that it was necessary to keep the mortgagor a going concern, nor the fact that the mortgagor*

> *pledged or mortgaged the current income to secure it, will give the claim a preferential equity over the lien of a prior mortgage*" (id., pp. 148-149). (Italics ours.)

In the case of *Rhode Island Locomotive Works v. Continental Trust Co.* (108 Fed., 5), the consideration for the claim was twelve locomotives. A strong Circuit Court of Appeals, composed of Judges Lurton, Day and Severens, denied the preference holding that, "The most that can be said to justify so large a purchase of additional equipment is that it was necessary to *the enlargement of the capacity* of the railroad company to conduct its traffic" (id., p. 7).

Exactly the same language might be applied to the claims at bar.

It is true that the Court in the case last cited also found that there had been no diversion of current earnings, but this was merely an additional ground for denying the claim and detracts nothing from the force of the Court's opinion on the ground first stated.

In the case of *Niles Tool Works v. Louisville, N. A. and C. Ry. Co.* (112 Fed., 561), the claim was for the price of three boilers sold by the claimant to a mortgagor railroad company, and used by the latter in connection with the construction of shops owned by a second company under a contract whereby the mortgagor company acquired the use of same by lease. After discussing the doctrine of *Fosdick v. Schall* (supra), the Court held as follows:

> "Since that opinion, however the rule has become

firmly established that indebtedness contracted by the mortgagor for improvements which are work of original construction and not mere repairs cannot displace the mortgage liens, though the mortgaged property is thereby improved" (id., p. 563).

It is also true that in the case last cited there was no diversion of income, but the Court held that *aside* from this the claim did not "come within the limited class of expenditures for which such allowance is authorized" (id., p. 562).

One of the best considered opinions of any Circuit Court of Appeals on this subject is to be found in the case of *Rodger Ballast Car Co. v. Omaha K. C. and E. R. Co.* (154 Fed., 629). In that case the Eastern Railroad Company held a railroad about sixty-eight miles in length, and a lease of the road of the Quincy, Omaha & K. C. Railroad Co., which was about one hundred and thirty-four miles in length. It was operating both of these roads. It had two mortgages covering its own railroad, and its lease of the Quincy road. The operation of the latter road was essential to the successful operation and business of the Eastern road. In the year 1899, both roads were in bad condition, particularly the Quincy road; portions of its roadbed had been only partially ballasted, the sides of the roadbed were washed, many of the cuts upon the road were badly filled, some of the ties were decayed and some of the bridges had become dangerous—"so that it was necessary to the safe operation of these roads and to the continuance of the business of the Eastern Company that many miles of this roadbed should be re-

ballasted and surfaced" (id, p. 631). So serious was the condition of the road that the Board of Railway and Warehouse Commissioners of the State of Missouri, in August, 1899, issued a *peremptory order* to the Eastern Company, under a possible penalty of the suspension of all traffic upon its roads, that this condition should be remedied. Ballast cars were necessary to the performance of this work, and in September, 1899, the Eastern R. R. bought of the plaintiff thirty-two ballast cars and one plow car for the sum of approximately $26,000, which it never paid. Within less than four months thereafter, Receivers of the road were appointed, who took possession of the ballast cars, operated the railroads and ballasted and resurfaced the Quincy road.

The opinion of the Court is based squarely upon the question as to whether or not the expense of these ballast cars was a current expense of the operation of the Railroad Company's business. The Court first referred to and quoted from at length *Illinois Trust and Savings Bank v. Doud* (105 Fed., 123), which we have cited above. It then held as follows (p. 632):

> "An examination of the opinions of the Supreme Court upon this subject since the decision in the *Doud* case was rendered discloses no modification of these propositions of law, *save that the class of claims which may be preferred has been still farther restricted by the holding in Gregg v. Metropolitan Trust Co.,* 197 U. S., 183, 25 Sup. Ct., 415." * * * (Italics ours.)

It then assumed for the purposes of its decision the

very facts which the claimants in this case contend are conceded by stipulation, and upon which they lay such stress, in the following language:

> "For the purposes of this decision the concession is made that the purchase of the ballast cars was *necessary to keep the Eastern Company a going concern and to continue its business and operation,* and that their purchase conserved and improved the mortgaged property and increased the security of the bondholders secured by the mortgages. But neither the fact that the consideration of a claim preserved and improved the mortgaged property and increased the security of the mortgagees, *nor the fact that it was indispensable to keep the mortgagor a going concern and to continue its operation and business, will give to the claim a preferential equity over the lien of creditors secured by a prior mortgage. Illinois Trust and Saving Bank v. Doud,* 44 C. C. A., 415, 105 Fed., 149, 52 L. R. A., 481; *Atlantic Trust Co. v. Dana,* 128 Fed., 209, 227, 62 C. C. A., 657, 675. There is *another* indispensable attribute of a preferential claim. It is that its consideration was a *current expense of the operation of the mortgagor incurred in the ordinary course of its business within a limited time, usually six months, anterior to the appointment of the receiver*" (id., p. 632). (Italics ours.)

After reviewing the *Carnegie Steel* and *Lackawanna cases,* referred to supra, the Court further held as follows:

> "A current expense incurred in the ordinary course of business within six months prior to a

receivership is a *usual* expense incurred in the *customary* course of the business of the company. The evidence in this case fails to convince that the purchase of these thirty-three cars for $26,192.05 by a railroad company operating 168 miles of railroad was the incurring of such an expense. *There was no evidence that the company had ever bought such a lot of cars before, or that in the ordinary course of its business it was accustomed to purchase such a lot once in three months or in six months or in any specific number of months, as a part of the current expenses of its operation*" (id., p. 633). (Italics ours.)

So in the case at bar the evidence fails to convince (a) that the purchase at an expense of over $38,000 of 90 miles of copper cable to be used over 30 miles of new transmission line, representing approximately 30 per cent. of the total power transmission line owned by the company; or (b) that the purchase of over $48,000 worth of new machinery which generates approximately 60 per cent. of the total power generated by the one power plant directly owned and operated by the defendant company, is the incurring of a "*usual expense* incurred in the *customary* course of the business of the company." Nor is there in the case at bar, any more than there was in the case last cited, any evidence that the defendant company had ever bought such a lot of copper cable or machinery before, "or that in the ordinary course of its business it was customary to purchase such a lot once in three months or in six months or in any specific number of months, as a part of the current expenses of its operation."

In the case of *Central Trust Co. v. Colorado Light and Power Co.* (200 Fed., 85), the intervener claimed a preference for repairs made to certain new boilers. When erected they were not designed for immediate use, but apparently intended ultimately to supplement the power at defendant's plant. The Court held as follows (id., p. 89):

> "It may be assumed, therefore, that the boilers, when repaired, *would conduce to the greater efficiency of the plant,* and thus, as repaired, made the Trust Company's mortgage to that extent more amply secured. *But the repairs were in no sense current expenses of the defendant, nor incidental to the ordinary operation of the plant. They were designed to its extension and enlargement, and were thus in the nature of betterments, looking toward a more adequate plant.*" (Italics ours.)

It is true that there was no diversion of income proved but we cite the case as an apt illustration of what may *not* be properly considered a current operating expense. As in the case at bar the new boilers were designed to the "extension and enlargement" of the plant. This immediately removed the claim based thereon from the class of current operating expenses.

One of the latest cases on this point decided by the Circuit Court of Appeals for the Eighth Circuit, in a decision handed down in December, 1915, has clearly and forcibly summarized the modern doctrine with respect to the classes of claims which are allowed preference as follows:

"The class of claims which under the decisions of the Supreme Court may lawfully receive an equitable preference in payment out of the income or out of the corpus of the property of a mortgaged railroad over the bondholders secured by a prior mortgage is limited *to claims incurred for the current expenses of the ordinary operation of the mortgaged property in the usual course of the business of the mortgagor. The test of the preferential equity of a claim is its consideration.* If its consideration was a *current expense* of the *ordinary* operation of the property of the mortgagor incurred in the *usual* course of its business, for labor, supplies, and like things, necessary for the operation of the railroad, within a limited time, usually not exceeding six months anterior to the appointment of the receiver, the claim may be preferred in payment, *otherwise it may not be.*" (Italics ours.)

> *Love v. North American Co.,* 229 Fed., 103, at page 107;

See also

> *Atlantic Trust Co. v. Dana,* 128 Fed., 209, at page 226;
> *Lee v. Penn Traction Co.,* 105 Fed., 405, at pages 406, 407.

Cases Decided in the Ninth Circuit.

We have reserved for separate discussion the decisions of the Federal Courts of the Ninth Circuit, touching upon this subject, namely:

Atlantic Trust Co. v. Woodbridge C. and J. Co., 79 Fed., 39;
California S. D. and T. Co. v. Yakima Inv. Co., 82 Fed., 542;
New York G. and I. Co. v. Tacoma R. and N. Co., 83 Fed., 365;
Spencer v. Taylor Creek Ditch Co., 194 Fed., 635.

In *Atlantic Trust Co. vs. Woodbridge Canal and Irrigation Company,* 79 Fed., 39, the claimant was a laborer who filed a petition alleging that the defendant company was indebted to him in the sum of $278 for work and labor done by the petitioner "in the construction, alteration, addition to, repair and supervision of its said ditches and canals as a laborer at its request." A demurrer was filed to the petition. Judge McKenna, after reviewing such of the cases on the question of preferential claims as had been decided prior to that time, held as follows:

> "In applying the principles which I have enunciated to the case at bar, there is some uncertainty. The allegations of the petition are somewhat confusing. They assign the services to construction, repairs and expenses of operation. *As far as they were for construction, they must be governed by the case of Railway Co. v. Hamilton,* 134 U. S., 296, 10 Sup. Ct., 546, *and cannot be given preference.* So far as they are for repairs and improvements, they cannot be given preference, as there is no allegation of diversion of income, nor, indeed, of the receipt of any income. So far as they are for operation—keeping the works a going concern

—they are within the principles declared, and may be entitled to preference, even out of the corpus. What the services were actually for, I assume the evidence will show, and then can be determined the class to which they belong" (id., 42). (Italics ours.)

This decision antedated the *Carnegie Steel* and *Lackawanna* cases, also the *Gregg* case, but even so, it clearly draws the distinction between claims for construction and claims arising out of operation.

The next case was that of *California Safe Deposit and Trust Co. vs. Yakima Inv. Co.*, 83 Fed., 542. We have already analyzed and quoted from this case at some length. It again clearly laid down the distinction between construction and operating claims, and held that claims for additions made after the road had been put in operation fell in the same category as claims for construction of the original main line (id. 545). The decision is peculiarly applicable to the services and other extensions for which preference is claimed in the present case.

The next case is that of *New York Guaranty and Indemnity Co. vs. Tacoma Railway and M. Co.*, decided in October, 1897, and reported in 83 Fed., 365. The Court held that a claim for $620 for a cable rope furnished by the intervener to a street railway company, and which was actually used by the company in the operation of its line for a period of 119 days, and which it was stipulated by all parties was actually necessary for the operation of the road dur-

ing that period of time, was entitled to a preference. The Court bases its decision squarely upon the "going concern" theory, which was eight years later repudiated by the Supreme Court of the United States in the case of *Gregg vs. Metropolitan Trust Company,* 197 U. S., 183. Indeed Justice McKenna's dissenting opinion in the *Gregg* case cites the *New York G. and In. Co. vs. Tacoma R. and M. Co.,* as one of the cases at Circuit, holding contra to the majority decision of the Supreme Court in the *Gregg* case, and presumably, therefore, as having been overruled by the *Gregg* case. However, even in the *Tacoma Railway* case the Court held as follows:

> "We do not think, as contended for by counsel for appellants, that the cable can be regarded in the light of repairs, or for construction or improvements, within the sense of the rules laid down by such decisions as *Railway Co. v. Hamilton,* 134 U. S., 296, 10 Sup. Ct., 546; *Thomas v. Car Co.,* 149 U. S., 110, 13 Sup. Ct., 824; and other cases of a like character."
>
> 83 Fed., 369.

But the Court, it seems, did not then regard the question as to whether the claim was for operation on the one hand, or improvement or construction on the other hand, as of importance, as is illustrated by its immediately succeeding language:

> "The question here is not so much whether the cable involved in this claim for preference is to be regarded in the light of repairs, or for construction, or as an improvement, or in the nature of

> materials or supplies furnished; but it depends upon the inquiry whether or not it was necessary to keep the road a 'going concern,' within the meaning of this expression as it is used by the Supreme Court in the cases cited above" (id. 369).

That the Circuit Court of Appeals of this Circuit has since fully recognized that the *Gregg* case once and for all disposed of the "going concern" theory is illustrated by the following excerpt from the recent opinion of this Court in the case of *Moore v. Donahoo,* 217 Fed., 177, where, after quoting from the *Gregg* case, the following language was used:

> "If by this language any doubt were possible of the intention of the Court to disapprove of the 'going concern' theory, the dissenting opinion most clearly indicates that it was this precise question upon which there was a division" (id. 181).

Leaving this aside, however, and coming back merely to the question of whether the claim in the case of *New York G. and Ir. Co. v. Tacoma R. and M. Co.* should properly have been classified as construction or operation, let us examine such of the facts in that case as the opinion discloses.

In the first place, the Court says that without this cable rope "this *portion* of the cable railway system could not be operated at all" (id. 368). Presumably, therefore, the rope in question was in use over only a part of the road, and from the fact that the claim was only for $620, we may safely assume that it was but a *small* part of the road, and that the amount of

rope furnished was comparatively unimportant. There was no question involved in that case, of furnishing 90 miles of copper wire of great value to be used over thirty miles of *new* road then under construction, as is the fact in the case of the Roebling claim, nor was there anything to show that as a result of furnishing the rope the capacity or power of the railway company was vastly increased, as is the fact in the I. P. Morris claim, with respect to the Swan Falls Power plant machinery. For all that appears, the claim was for a comparatively insignificant amount of rope, to replace a portion that had been worn out by use and operation. Under no circumstances, therefore, can the *Tacoma Railway* case be considered as authority contrary to the main contention which we make in the case at bar.

The *latest* case, however, in this Circuit upon the precise point is that of *Spencer vs. Taylor Creek Ditch Co.*, 194 Fed., 635, decided in February, 1912, *after* the decision in the *Doud* case, *Rodger-Ballast* case, the *Gregg* case, and many others, as a result of which the law became definitely settled.

The facts in the *Spencer* case were as follows: A mining company in Alaska gave three mortgages on its property, the second of which covered after-acquired property. Foreclosure was commenced on June 22, 1907, by the first mortgagee against the second and third mortgagees, and the mining company. Thereafter, and in a suit then pending in the same court, wherein Spencer was plaintiff and the mining company was defendant, a receiver was appoint-

ed. The receivership was thereafter extended over the property involved in the foreclosure suit, and permission given to intervene in the creditors' suit in behalf of unsecured claims, as follows:

(1) For labor and supplies for the construction of the Henry Creek Ditch.

(2) For the repair and maintenance of Coffee and Arctic Creek Ditches.

(3) For labor performed in doing assessment work on sundry unnamed, unpatented mining claims.

The Court first considered the question as to whether or not a mining corporation could properly be considered as a public service corporation or a quasi public service corporation. It then held as follows:

> "But, *aside from the character of the corporation,* if we turn to the claims themselves in the present case, we find that they do not measure up to the standard required of claims admitted to priority over mortgages in the case of defaulting railroads. *They are not claims for current expenses;* that is to say, for expenses which in the ordinary course of business would have been paid by the corporation out of the current income had not the Court interfered and appointed a receiver of the property. In High on Receivers (4th Ed.), Sec. 394-h, the author *states the law* with respect to such claims as follows:
>
> " 'Claims of general creditors of a railway company, which have been incurred prior to the receivership, and which do not fall within the class of current expenses for the ordinary operation and

maintenance of the road, such as necessary labor, supplies, materials or equipment, and which do not, therefore, have any special equities entitling them to payment out of current income, will not be preferred out of the earnings of the receiver, or out of the proceeds of the foreclosure sale. The allowance of claims, which results in the displacement of the priority of mortgage liens, is to be regarded as the exception and not as the rule, and such claims will not be given a preference unless they may fairly and reasonably be regarded *as debts incurred in the ordinary, daily operation and maintenance of the road.* And where the expense is an *extraordinary* one, incurred outside the ordinary course of business of the road, such as for original construction or reconstruction, *or for extraordinary repairs, or for extensions or permanent improvements, the preference will not be granted'"* (id. 641). (Italics ours.)

This Court in the *Spencer* case, therefore, adopted the above quoted rule as expressed in High on Receivers, and thus clearly declared it to be the law of this Circuit that expenses for *"original construction," reconstruction* or for *extraordinary repairs,* or for *extensions,* or *permanent improvements,"* will not be granted a preference.

The *Spencer* case has never been criticised or overruled; it stands as the law of this Circuit, and in itself is sufficient to preclude the Roebling and the I. P. Morris claims (which are clearly for *construction* and cannot accurately even be termed extraordinary repairs) from being accorded any special, equitable preference.

It cannot properly be contended that in deciding the *Spencer* case this Court overlooked the case of *New York G. and I. Co. v. Tacoma R. and M. Co.*, supra, because a reference to the printed papers on appeal in this Court in the *Spencer* case discloses that the *New York Guaranty v. Tacoma R. and M. Co.* case was cited by counsel for Spencer in his brief. For the reasons above stated, we do not consider that the two cases upon this particular point are irreconcilable, but if we are wrong in this, then, surely, the authority of the latter case must be deemed superior.

We might add that counsel for the appellant, in his brief in the *Spencer* case, advanced many of the very same contentions advanced by the appellants in the case at bar.

The appellants rely upon *Railroad Company v. Lamont*, 69 Fed., 23, which was cited in the *Tacoma* case. The intervener's claim in the *Lamont* case was for the expense of maintaining, on certain property which the railroad company had leased to the intervener, certain waiting rooms for passengers and office room for the ticket agent. The claim was clearly an operating expense, since all the intervener did was to maintain, warm and light certain rooms in the hotel building, which the railroad company had leased to him for the benefit of passengers and the ticket agent. Here was a daily and current operating expense. There was no question of construction or improvement or extension, or anything of that nature whatsoever.

Appellants also cite *Virginia Passenger and Power Co. v. Lane Bros. Co.*, 174 Fed., 513, where the claim was for labor and supplies in connection with excavating and removing earth and rock in the widening of a canal. It seems that the power plant had been operated prior to that time by steam and it was desired to operate it by water. The labor was performed within thirty days prior to the appointment of the Receivers. As soon as the latter were appointed, they filed a petition with the Court earnestly recommending that they be allowed to contract with the intervener for the continuance and completion of the work, stating that otherwise the plant might be shut down at any moment

> "and that the shutting down or serious disablement of this plant would stop all the cars in Petersburgh, throw the town into darkness and prevent the operation of the Richmond and Petersburgh Line" (id., p. 514).

It was further the fact that the intervener's contract with the railroad company contained a provision to the effect that payments were to be made monthly in "current funds." The Court allowed the claim. Apparently, it was influenced by the "going concern" theory, which, as this Court has pointed out in the case of *Moore v. Donahoo*, 217 Fed., 176, at page 181, was repudiated by the Supreme Court of the United States in the *Gregg* case. In fact, the following excerpt from the opinion of the Court in the *Virginia Passenger and Power Co.* case is directly con-

trary to the holding of the majority opinion in the *Gregg* case:

> "One of the foundations of the principle is that the public interest requires that a railroad must be kept 'a going concern.' It does not depend, therefore, upon the diversion or even upon the existence of income" (id., 516).

The Court, furthermore, was clearly very strongly influenced by the statement of the Receivers and of the General Manager of the Power Company to the effect that if the work in question had not been started and continued the plant would have been liable to have been shut down at any moment, with the result that the city which it served would have been thrown into darkness and all the cars stopped. The decision, therefore, cannot properly be considered an authority in favor of the appellant's contention.

The same is true with respect to *Central Trust Co. v. Clark,* 81 Fed., 269, decided in the Eighth Circuit in 1897, prior to the decisions of the same Court in the Doud case and the Rodger Ballast case. The Central Trust Company case was also decided upon the "going concern" theory subsequently repudiated by the Supreme Court of the United States in the Gregg case, and by later decisions of the Circuit Court of Appeals in the Eighth Circuit handed down subsequent to the Gregg case.

The appellants argue that, in determining whether claims of this character are for construction or for maintenance and operation, the amount of the im-

provement must be considered with reference to the value of the system as a whole (Appellant's Brief, p. 69), and they refer with insistence to the fact that the defendant company had a large capital stock and a large bond issue outstanding. In this connection, we repeat what we have already mentioned in our preliminary statement, that the properties of the Railway Company consisted in *two* systems—one, a hydro-electric power system, and the other, an electric railway system. It is true that the Railway Company had issued $3,625,400 of preferred stock and $12,566,200 of common stock and that there were several million of bonds outstanding. That the amount of securities outstanding, however, is no indication of the "value of the system" is demonstrated by the fact that the property sold under foreclosure for only enough to pay approximately *fifty-three cents on the dollar to the bondholders,* so that both the preferred and the common stock must be deemed to have been worthless. If any further answer is required to this contention, it is to be found in the opinion of Judge Dietrich in the Court below, where he held with respect to the I. P. Morris claim as follows (Transcript, p. 144) (italics ours):

> "Furthermore, in considering the character of the work done, and also the sources from which it is reasonable to assume the claimant expected payment to be made, it will not do to compare the cost of the machinery purchased from the claimant with the aggregate value of all the Railway Company's properties. The latter owned not only the

generating plant for which this apparatus was supplied, but also the transmission and distributing systems, and traction properties. *The generating plant alone is here to be considered as the basis of comparison.* What was the relation of the new work to this unit? And if we consider cost and values at all, what is the ratio of not merely the intervener's claim but of the entire cost of new work, including the intervener's claim, to the cost or value of the whole generating plant? As is made plain by the stipulations and the testimony relating to this and other claims, this was not the only expense which the Railway Company was compelled to incur in order to increase its revenue. Some of the additional output, it is true, could be disposed of to new consumers upon existing lines, but not all, for the transmission and distribution of much of the current to be developed by the new installation, new lines into new fields had to be constructed; and, besides, the intervener's claim was but one item in the expense of enlarging the power plant itself."

The important fact to remember is that one of these claimants furnished the machinery, which produces approximately 60 per cent. of the present capacity of the power plant, and the other claimant furnished the copper cable necessary to construct *the new thirty-mile transmission* line which was built to *utilize* the *increased capacity* of the power plant.

We, therefore, respectfully submit that if claims of this character are to be considered "maintenance", "operation", or "ordinary repairs", then there is hard-

ly any conceivable material and supply claimant who may not with equal force properly urge that he is entitled to similar favor, and the "sacredness of contract obligations" and "the vested and contracted priority" of the bondholders (*Kneeland v. American Loan Co.*, 136 U. S., at p. 97) will become a thing of form rather than of substance.

II.

The claimants utterly failed to sustain the burden resting upon them to show a diversion of current income earned before the accrual of the debts upon which their claims are based.

Entirely irrespective of the question as to whether or not the claims before the Court were properly chargeable to capital account or to current expense account, the claimants would, of course, have no standing so far as a preference is concerned, unless they established a so-called "diversion of income". This obviously follows from the decision of the Supreme Court in *Gregg v. Metropolitan Trust Company* (supra). Apparently recognizing that this is true, the attorney for the appellant at page 19 of his brief makes the following statement:

> *"The principal assignment of error and the chief reliance for reversal of the decree are based upon the wrongful diversion of the income,"* etc.

Before discussing the facts upon which the appellants attempt to predicate "diversion of income" it is

desirable to review briefly a few of the well-known principles bearing upon this subject.

a.

The burden of proving a diversion of income rests upon the claimant.

> *Central Trust Co. v. East Tennessee, V. and G. R. Co.,* 80 Fed., 624, at p. 626;
> *Kansas Loan and Trust Co. v. Electric Railway Light and Power Co.,* 108 Fed., 702;
> *Fordyce v. Omaha, Kansas City and E. R. R. Co.,* 145 Fed., 544, at p. 562;
> *St. Louis, Alton and Terre Haute Railroad Company v. Cleveland, Columbus, Cincinnati and Indianapolis Railway Co.,* 125 U. S., 658, p. 674;
> *Lincoln Trust Co. v. Missouri Water, Light and Traction Co.,* 131 S. W., 889, at p. 891.

In the case of *Central Trust Co. v. East Tennessee, V. and G. R. Co.,* 80 Fed., 624, Judge Lurton (Taft and Severens, JJ., concurring) used the following language at page 626:

> "The burden is upon complainants to show that there has been a misappropriation of earnings to the improvement of the mortgaged property or to the payment of interest, before the mortgagees can be justly called upon to reimburse the fund applicable to debts of the income in consequence of such diversion. If interest was paid or improvements made out of borrowed money, then

there was no diversion; or if made out of gross earnings, and the latter was reimbursed by borrowed money, the diversion was made good."

In the case of *Kansas Loan and Trust Co. v. Electric Railway Light and Power Co.,* 108 Fed., 702, the Court held as follows:

> "As the intervener's right to a preferential claim is dependent upon the fact that there has been a diversion of the net earnings of the mortgaged property over and above the necessary expenditures for operation, and that such diversion has inured to the benefit of the mortgagees (*Bank v. Doud,* 105 Fed., 123), *the burden of proof rests upon the intervener to establish this fact.*" (Italics ours.)

In *Fordyce v. Omaha, Kansas City and E. R. R.,* 145 Fed., 544, at p. 562 the Court held as follows:

> "Before the intervener can charge the corpus of the property in the hands of the purchaser with the payment of its claim, the burden is upon it to show that but for such diversion there would have been a net surplus of earnings subject to the equitable lien".

In *Lincoln Trust Co. v. Missouri Water, Light and Traction Co.,* 131 S. W., 889, at p. 891 the Court held:

> "Whatever may be the tendency of modern jurisprudence to favor the payment of 'last illness' expenses of defunct corporations over mortgage debts, the burden is on the claimant to show that

his demand was for sustenance that prolonged the life of the expiring corporation, and that funds which should have been used to discharge a debt so sacred were diverted to the payment of mortgage debts or other less sacred obligations."

b.

A mortgagor railroad company is not bound to accumulate a surplus to meet possible deficiencies in the income to pay future income debts.

In *Central Trust Co. of New York v. East Tennessee, V. and G. R. Co.,* 80 Fed., 624, at p. 626 the Court held as follows:

"Prior to the period covered by the maturity of appellants' claims, there was a surplus of gross earnings over all operating expenses; but it cannot be contended that the company was under any obligation to future creditors to accumulate a surplus to meet possible deficiencies in the income to meet future income debts, or that it was improper to apply such surplus in payment of interest. *St. Louis, A. and T. H. R. Co. v. Cleveland, C. C. and I. Ry. Co.,* 125 U. S., 658-675, 8 Sup. Ct., 1011."

c.

So-called diversions prior to the creation of the debts sought to be enforced as an equitable lien cannot be availed of by claimants seeking a preference.

In *Kansas L. and T. Co. v. Electric Railway L. and P. Co.,* 108 Fed., 702, at p. 703 the Court held as follows:

> "This intervener has nothing to do with the earnings of the road, or their diversion by the road, *prior* to the creation of its debt. The creditor can only concern himself about diversions of the current earnings *after* the creation of his debt." (Italics ours.)

In the case cited the Court referred the matter back to the Master, among other things "to make an amended report therein, setting out the substance of the testimony in the case before him respecting this claim, with an ascertainment, if found in the evidence, *of what were the current gross earnings from the operation of the property on which the lien is sought to be enforced* AFTER *the creation of the interveners' claim* up to the time of the appointment of the Receivers, and what were the net earnings, if any, *during that period* after deducting the ordinary expenses of operating the property" (id., p. 704). (Italics ours.)

See also *Fordyce v. Omaha, Kansas City and E. R. R. Co.*, 145 Fed., 544, at p. 555.

It is apparent from the foregoing that in determining the question as to whether or not there has been a diversion of *current* income the Court can only consider income earned *after* the creation of the debts. This of course is entirely consonant with the logic of the whole doctrine under discussion and with common sense. A railroad company which is enjoying a net income may properly assume that *subsequently* earned income will be sufficient to take care of *subsequently*

maturing income *debts,* and may, therefore with absolute propriety, pay out any *present* surplus of net income in payment of bond interest or for construction work. If the rule were otherwise, it might be impossible for railroads under certain circumstances to finance themselves. Even in *Fosdick v. Schall,* the Court stated that the implied agreement of the railroad mortgagee was merely that the *current* debts made in the ordinary course of business should be paid "from the *current* receipts".

Bearing in mind, therefore, that the burden of proving a "diversion of income" is upon the claimants; that a mortgagor railroad is not bound to accumulate a surplus of net earnings to take care of *future* operating debts, and finally that in order to create a so-called "diversion" the gross earnings applied in payment of bond interest must have been earned *after* the accrual of the debts for which preference is claimed, let us now examine such facts bearing upon this subject as the record before this Court contains.

First: As to the Roebling claim. The so-called diversion upon which counsel for the appellants relies is the payment on June 1st, 1913, of interest on the bonds of the defendant company held by the Guaranty Trust Company amounting to $165,750.00, interest on the bonds of the Boise and Interurban Railroad Company amounting to $26,825.00, and interest on the bonds of the Boise Railroad amounting to $9,725.00, making a total of interest paid of $202,300.00 (see Appellants' opening brief, p. 11).

Of this amount, however, $56,750.00 was derived from the proceeds of sale of the Company's bonds, and $30,000.00 was borrowed on the Company's note from Kissell, Kinnicut and Company, making a total of $86,750.00 derived from sources other than earnings. Deducting this last amount from the $202,-300.00, which was paid out, leaves a balance of $115,-750.00, which claimants contend was the sum diverted from earnings. Before discussing the question as to when this sum was earned, we call the Court's attention to the fact that it includes $9,725.00, representing interest on bonds of the Boise Railroad Company. This last payment, however, did not inure to the benefit of the bondholders of the defendant company. As to this the following appears in the decree of the Court below (Tr., p. 160): "Nothing herein contained shall be construed to charge the said Guaranty Trust Company or bondholders represented by it with interest or construction payments made on account of said Boise R. R. Co., *the properties of which have been decreed not subject to the mortgage of the said Guaranty Trust Company and have been segregated from the Receivership estate.*" So that at the outside the most that can possibly be claimed by the appellants is that $105,825. was diverted.

It is of the utmost importance, however, to note that the earnings from which this payment was made were all earned *prior* to June 1st, 1913, and in fact all but a little over $1,000. of such earnings was earned before *May 1st*, 1913. The stipulation of facts (Tr.,

p. 43) shows that deposit reserves were made by the Railroad Company from its earnings and from the proceeds of sale of its bonds to pay bond interest as follows:

December,	1912—Deposit reserve	$ 24,345.33
January,	1913—Deposit reserve	26,746.
February,	1913—Deposit reserve	25,545.65
March,	1913—Deposit reserve	31,029.16
April,	1913—Deposit reserve	26,916.66
May,	1913—Deposit reserve	1,166.70
Total	....	$135,750.

In other words, during the six months prior to the date of the alleged diversion more than $20,000. in excess of the largest amount which the claimants can properly contend was diverted had been derived by the company from its earnings during the said six months' period and from the sale of bonds.

The record does not show when the different items of which the Roebling claim consists were delivered, except that it states that the supplies and material in question were sold and delivered between the 18th of March, 1913, and the 30th day of May, 1913 (Tr., p. 42). The payment for this copper cable was not due, however, until thirty days from the delivery of the various items (Tr., p. 42). The earliest date therefore when there can properly be said to have been any debt due from the defendant company to the Roebling Company was on the 18th day of April, 1913, viz.: 30 days after the first date when anything was delivered. A reference to the tabulation of de-

posit reserves, however, discloses the fact that at that time there had *already* been earned and set up by the defendant company as a deposit reserve to pay bond interest the sum of $134,583.30, namely, the entire total of deposit reserves above set forth, except the deposit reserve for May, which only amounted to $1,166.70.

Furthermore, it is to be noted that included in the amount which the claimants contend was diverted was the interest on the bonds of the Boise and Interurban R. R. Co. amounting to $26,825. *This payment, however, was made on April 1st,* 1913, only thirteen days after the account of the claimant was opened and seventeen (17) days before anything was due thereon. From any point of view, therefore, it is impossible to treat the payment of interest on the bonds of the Boise & Interurban R. R. Co. as a diversion.

But the appellant Roebling will contend that even though the income was earned *prior* to the accrual of its claim that neverthelss the *payment* thereof was not made until June 1st thereafter. The date of the *payment* of the interest, however, was a mere accident. It might have fallen on the 1st of May or the 1st of April. It merely *happened* to fall on the 1st of June. The important fact is that the *earnings* from which payment was made had practically all accrued by April, *prior* to the accrual of the Roebling debt, and had prior to such accrual actually been *appropriated and set aside* by the Railroad Company to meet the bond interest.

We therefore submit that there is not the slightest justification for claiming a diversion of income as to the Roebling claim.

This claimant has heretofore contended that it sold the goods in the belief and in the intention "that the same should be paid out of *current* operating income."

Does it *now* claim that it sold goods in the intention and belief that they should be paid for out of *past* operating income? If so, how does it reconcile this claim with the allegations in its bill, paragraph IX, as follows:

> "Your intervener further shows and represents to your Honors that large sums of money received by said Idaho Railway Light & Power Company as income from the operation of the properties of said corporation *subsequent to the sale and delivery thereto* by said intervener of material and supplies herein described, have been diverted from the funds of said corporation available for the payment of said accounts of this intervener as follows * * * notwithstanding the fact, that the material and supplies so sold and delivered by intervener, as herein alleged, to the said Idaho Railway Light & Power Company has been added to the property of said corporation and has increased the value thereof and the security of the holders of said mortgage bonds to the extent of the value of said material and supplies so sold and delivered, the income and revenue derived from the operation of said properties, *and due in part to the use of the said material and supplies,* has been by said corporation paid to the said Guaranty Trust Company

> of New York as Trustee on account of interest upon said bonded indebtedness" (Tr., pp. 36 to 38).

In other words, in its bill of intervention this claimant charged that the income which was "diverted" had been received by the defendant company *subsequent* to the sale and delivery of the merchandise on which it bases its claim, and it seeks to emphasize the injustice of such conduct by also alleging that the income and revenue so diverted was due in part to the use of the very material and supplies which it furnished.

Thus this claimant has *alleged* that the income which was diverted had been earned *after* its claims had accrued. The *record* shows, however, that the moneys paid out in payment of bond interest were derived from earnings made *prior* to the accrual of claimants' debt.

SECOND: As to the I. P. Morris claim. The alleged diversion is claimed to have taken place on June 1st, 1913. The receiver was not appointed until December 23rd, 1914, nearly seven months thereafter. The I. P. Morris Company in its bill of intervention alleged with respect to the machinery and labor which it respectively furnished and performed:

> "That such machinery was all furnished and such labor performed at the special instance and request of the said Railroad Company during the year 1913, *and within six months prior to the appointment of the said O. G. F. Markus as receiver of the said Railway Company*" (Tr., p. 53).

At page 35 of his opening brief counsel for the appellants makes the following statement in connection with his discussion of the "six months rule":

> "The material and labor upon which the I. P. Morris Company claim is based was furnished and supplied *within six months before the appointment of receiver,* and the question does not arise in respect to that Company's claim."

In his anxiety to escape from the effect of the six months' rule, counsel for the I. P. Morris Company has impaled himself upon the other horn of the dilemma. If, as his client has alleged in its bill, and as he claims in his brief, the Morris claim did not accrue until within six months prior to the appointment of the Receiver, then he is out of court on the question of diversion of income. This is true, quite irrespective of whether the the payment of June 1st (insofar as it constituted a payment out of earnings at all) represented earnings practically altogether made by the Railroad Company prior to May 1st, 1913, because obviously if the Morris claim did not accrue until within six months of the appointment of the Receiver on December 23rd, 1913, it could only have accrued *after* the payment of interest on June 1st, 1913.

> "Payments of interest are not a diversion of earnings as regards a creditor to whom there is nothing due at the time those payments are made."

Short on Law of Railway Bonds and Mortgages, p. 606, Section 614; *Foster Federal Practice,* 5th Edition, Vol. 1, Section 305, Section 962, Note 23.

Before we leave this subject, we wish to call to the attention of the Court that the date of the alleged diversion, namely, June 1st, 1913, was nearly seven months prior to the date of the appointment of the Receiver, and therefore outside of the six months' preferential period. Furthermore, there were but a few isolated diversions in this case, only two of which are before this Court. Under these circumstances, there is no question of marshaling numerous claims with reference to diversion, and calculating the distributive share to which each is entitled which this Court in the *Donahoo* case, pointed out might be difficult.

On the contrary, the situation with regard to the claims at bar is that we have two isolated claims and one isolated alleged diversion, and no *proof* that the payment of June 1st represented earnings earned and received by the defendant company *subsequent* either to the accrual or maturity of the appellants' claims.

III.

Concededly the Roebling claim accrued more than six months prior to the appointment of the Receiver. Either the same is true with respect to the I. P. Morris claim, or there was no diversion of income after the accrual of that claim. In neither case is there any special equity requiring the Court to disregard the six months' rule.

The appellants in their opening brief, at page 35, state that the claim of the Roebling's Sons Company "was incurred about seven months before the appointment of the Receiver". The material was sold and delivered between March 18 and the 30th of May, 1913, but the record, as we have heretofore pointed out, does not show how much was delivered on any particular day or days during that period. It would be more accurate, therefore, to say that the merchandise upon which this claim is based was sold and delivered to the defendant company during the period from over nine months to approximately seven months prior to the appointment of the Receiver in the creditors' suit, and from ten to eight months before the institution of the foreclosure proceeding and the extension of the receivership to such proceeding.

In the case of the I. P. Morris Company claim, however, counsel for the appellants states that the material and labor upon which the same is based was "furnished and supplied within six months before the appointment of the Receiver, and the question does not arise in respect to that Company's claim" (p. 35). As we have pointed out under Point II, however, if

the I. P. Morris claim did not mature until within six months of the appointment of the Receiver, then it necessarily matured *after* the only payment which it is contended constituted a diversion of income, namely, the payment of the bond interest on June 1, 1913. In order, therefore, to establish a *subsequent* diversion, it is necessary for this claimant to make its claim date as of the date of the contract itself, namely, October, 1912. By so doing, however, the claim becomes stale under the six months' rule.

But the appellants' counsel takes the position in his brief that there *is* no such thing as a "six months' rule". We do not contend that there have not been sporadic instances where courts of equity have allowed as preferential, claims which matured more than six months before the appointment of the Receiver in the foreclosure proceedings. We *do* maintain, however, that the *general* rule is the other way, and that it is only in *special* and *extraordinary cases,* where the circumstances are so unusual as to create an equity in the claimant entirely beyond the common, that there has been any variation from the general rule.

In one of the earlier cases on the subject, Mr. Justice Harlan of the Supreme Court of the United States, then sitting as Circuit Justice in the case of *Thomas v. Peoria and R. I. R. R. Co.,* 36 Fed., 808, discussed the six months' rule with much clearness and authority, as follows:

> "Upon these grounds, substantially, rests the rule that recognizes the right of the Court to charge the income earned during the receivership

with obligations for labor, supplies and equipment, contracted by the railroad company *during the six months immediately preceding the receivership.* Such debts constitute operating expenses incurred to the end that mortgage bondholders might be protected, and that the company might be kept upon its feet, and subserve the public purpose for which it was established, namely, the maintenance of a highway for the convenience of the people. * * * It may be added that the grounds upon which the Court may charge the income of mortgaged railroad property, earned during the receivership, with debts for labor, supplies and equipment received prior to the appointment of the Receiver, are so fully stated in some of the cases cited—particularly in *Fosdick v. Schall*—that further discussion of them is unnecessary. *But I will say that the six months' rule was observed by me at the circuit when disposing of the case of Trust Co. v. Railway Co., and the final decree, so far as it rested upon that rule, was not disturbed by the Supreme Court.*" (Italics ours.)

Id., pp. 819, 820.

Lurton, C. J. (afterwards Justice), in his opinion in the case of *Central Trust Co. of New York v. East Tennessee, V. and G. R. Co., et al.*, 80 Fed., 624, held as follows with respect to the decision of Mr. Justice Harlan just quoted from:

"In the Seventh Circuit, we have the authority of Mr. Justice Harlan for saying that a limitation of six months has been regarded as a proper limitation upon such claims. *The precise grounds upon which such a rule rests are so well stated by the*

learned Justice that we quote and adopt his reasoning, as reported in Thomas v. Railroad Co., 36 Fed., 808." (Italics ours.)

Id., 629.

And again in the same opinion speaking of the rule of the Sixth Circuit, the Court held as follows:

"In this circuit a six-months rule has been almost universally imposed" (630).

It appeared in that case that the Circuit Court had passed an order providing for the payment of certain operating, supply and repair claims accruing within six months before the appointment of the Receiver. Mr. Justice Lurton there held, with respect to this order, as follows:

"The appellants present no *special circumstances* which will justify a departure from this general order, under which all such claims have been settled, and we feel altogether indisposed to *arbitrarily extend a limit imposed in the sound discretion of the Circuit Court.*" (Italics ours.)

Id., 630.

To the same effect see the opinion of Judge Blodgett, in ***Reyburn v. Consumers Gas, Fuel and Light Co.,*** 29 Fed., 561, at 563, where he used the following language:

"The doctrine of ***Fosdick v. Schall*** and the subsequent cases on the same question, is that, for the purpose of keeping works of a public character, within which the works of this company may be properly included in operation, those who have given the company credit for the supplies neces-

sary to keep the works in operation—current operating supplies—*are to have a lien extending back not to exceed six months, except under extraordinary circumstances.*" (Italics ours.)

Id., 563, 564.

See also the opinion of Sanborn, C. J., in *Rodger Ballast Car Co. v. Omaha, K. C. and E. R. Co.,* 154 Fed., 629, at p. 632.

"There is another indispensable attribute of a preferential claim. It is that its consideration was a current expense of the operation of the mortgagor incurred in the ordinary course of its business *within a limited time, usually six months, anterior to the appointment of the Receiver.*" (Italics ours.)

Id., 632.

It is true that in the case of the *N. Y. Guaranty and Indemnity Co. v. Tacoma Railway, etc.,* the Circuit Court of Appeals in this Circuit, said in its opinion (p. 370) that there is no fixed arbitrary rule, barring preferential claims that have been contracted more than six months before the appointment of a Receiver. The appellants' counsel makes much of this case, stating that a preference was allowed upon a claim therein for material purchased more than two years before the appointment of the Receiver. The Court, however, pointed out that the intervener had begun suit in the Washington state court before the Receiver was appointed, and only about twelve months after the delivery of the cable, and thereafter recovered a judgment, and then held that:

> "The period of time that transpired between the time that the intervener instituted its action and the appointment of the Receiver cannot properly be included in this computation of time."

It must also be observed that doubt has since been cast upon the authority of the *N. Y. Guaranty and Indemnity Company* case because it was decided upon the "going concern" principle, later repudiated by the Supreme Court of the United States in the Gregg case, as this Court itself has pointed out. (See *Moore v. Donahoo,* 217 Fed., 177.)

Irrespective of the foregoing, however, the decision of this Court in the case of *Spencer v. Taylor Creek Ditch Co.,* 194 Fed., 635, is decisive on this point. In the Spencer case two of the same judges were sitting who sat in the N. Y. Guaranty & Indemnity Co. case. In the interval between the two cases the *Doud* case, the *Rodger-Ballast* case, the *Gregg* case, and several other important Supreme Court cases, had been decided. all showing a decided tendency to restrict the doctrine of preferential claims of this character.

We have already reviewed the facts of the Spencer case under Point II of this brief. The appellants' counsel in his brief at page 35, in the case at bar, states that the claim in that case was contracted about a *year* prior to the appointment of the Receiver, but it appears from the opinion of the Court that there were several claims and that the period of default as to some of them might not have been more than nine months (id., 642). The Court held on this point as follows:

"Furthermore, stale claims are not allowed for expenses incurred prior to the appointment of a Receiver. Such claims to be admitted to priority must have been incurred within a reasonable time before the receivership to be admitted as 'current expenses'. In *Thomas v. Railway Co.* (C. C.), 36 Fed., 818, 819, Mr. Justice Harlan, sitting in circuit, in 1888 *stated a rule of limitation which has been observed by the courts ever since.* He said:

" 'The general rule that has obtained in this circuit for many years, though not fully or expressly formulated in any published decision, has been not to charge the income of mortgaged property accruing during a receivership, or the proceeds of the sale of such property with general debts for labor, supplies and equipment, *back of the six months immediately preceding the appointment of a Receiver.* While the Court has not, perhaps, committed itself against applying a different and more liberal rule, *when the special circumstances or equities of the case demand such a course, the general rule is as just stated; and I am unwilling in this case, and at this late day, to depart from it.* Besides, I am of the opinion that, under the circumstances that usually attend the administration of railroad property by the courts, through receivers, *the rule stated is a wise and salutary one.* It would not do to charge the income of mortgaged railroad property, managed by a Receiver, or the property itself, with every debt incurred in all its previous history for labor, supplies or equipment. As was said in *Fosdick v. Schall,* the business of all railroad companies is, to a greater or less extent, done on credit. Those who per-

form labor, or furnish supplies and equipment, usually expect and contract to be paid within a reasonable time; and they do not ordinarily perform labor, or furnish supplies or equipment after the railroad company has failed to pay within such time for what has been previously done or furnished. Expenses incurred within such reasonable time constitute what are called 'current expenses', which ought, if possible, to be paid out of the receipts during the same period. When, therefore, debts of that character remain unsettled, or are not put in suit, for such a time as would be deemed unreasonable, it may be fairly presumed that the creditors have ceased to look to current receipts for payment, and have accepted the position of general creditors who, as such would have no claim for indemnity upon any special part of the income.'

"In the present case the Receiver was appointed by the Court in the original action about July 1, 1907. The amended complaint in intervention in this case was filed October 31, 1908. The claims are for expenses incurred by the corporation in the mining season of 1906. The corporation must have been in default for more than a year with respect to many of these claims when the original action was commenced, and not less than nine months with respect to any of them. *We are not aware of any case that would admit to priority claims of this character."* (Italics ours.)

The extent to which the "six months' rule" is now generally regarded as prevailing is demonstrated in the discussion of the general doctrine of equitable preferences to be found in Cook on Corporations, 7th Edi-

tion, Vol. 4, Section 861. We quote therefrom as follows:

> "Section 861. *The 'six months' rule,' to the effect that labor and supply claims arising within six months prior to a Receiver being appointed will be paid out of the income received by the Receiver.*—When a Receiver of a railroad is appointed he commences at once to take the income from the operation of the road. This income at first is due largely to supplies furnished and labor done prior to the receivership. Accordingly it is but just that such claims, for a reasonable length of time prior to the receivership, should be paid out of the income received by him, especially as that income would have been used by the company for that purpose if the Court had refused to appoint a Receiver. *Six months have been fixed upon by the courts as the proper limit of past time during which labor and supply claims enter into the income received by the Receiver."* (Italics ours.)

The author then proceeds to discuss the different phases of the general doctrine, but it is interesting to note that, throughout, he uses the phrase "six months' rule" to characterize the entire principle of equitable preferences which found its genesis in *Fosdick v. Schall;* in other words, in the opinion of this careful and authoritative text book writer, the limitation of six months has become so firmly imbedded in the general principle that the latter takes its name from the rule of limitation.

A further reason why six months has been chosen by the courts as the proper limit is to be found in the

language of the Circuit Court of Appeals for the Eighth Circuit, in *Westinghouse Air Brake Co. v. Kansas City So. Ry. Co.,* 137 Fed., at page 26, where (at page 40) the Court held as follows:

> "Mortgage bondholders have the right to the payment by the mortgagor of the current expenses of the operation of the railroad by their debtor with reasonable promptness. *The reason that six months is approximately the limited time within which preferential claims must accrue is that there is usually an interval of six months between the dates when installments of interest upon the bonds fall due* * * *." (Italics ours.)

Such is the fact with respect to the mortgage of the Guaranty Trust Company in the case at bar, interest being due semi-annually on June 1st and December 1st.

The same Court further held as follows (137 Fed., 41):

> "The cases in which special circumstances have induced courts to prefer claims which accrued more than six months before the appointment of receivers, and in which extensions of times of payment have not proved fatal, are not out of mind. *But those decisions were induced by the peculiar equities of the respective cases, and the fact remains that the general rule is that the time within which claims which are entitled to payment out of the income or proceeds of the mortgaged property in preference to the mortgage debt must accrue is six months preceding the impounding of the income and the seizure of the property by the mortgagees.* 23 Am. & Eng. Enc. of Law, 816." (Italics ours.)

The appellants, however, cite a number of cases, at page 34 of their brief, to sustain their contention that courts of equity have not necessarily adhered to the six months' limitation. In *Skiddy v. Atlantic R. R. Co.*, 3 Hughes, 320, it seems that upon the appointment of the receiver it was discovered that there were wages in arrears for eight months back due to the then *present* employees of the road who had been continued by the receiver in his employ. The receiver represented to the court (id., 337) that unless all back wages due to employees "then actually in the employ of the company should be paid", he "would not be responsible for the consequences of a refusal of it by the court to the property of the company or the safety of passengers". In other words, the only alternative to payment was violence, destruction of life and property. Under these circumstances, the court naturally passed the decree authorizing the receiver in his discretion to pay the arrearage of wages, and for aught that appears, there was no opposition to this wise and practical disposition of the matter. There was no question of legal or equitable right, but merely one of expediency. It is further to be noted that with respect to claims for material and supplies furnished during the period of one year or more before the appointment of the receivers, and with respect to claims of *former* employees of the road, the court held that they were *not* entitled to any preference (id., 389).

The case of *Burnham v. Bowen*, 111 U. S., 776, is also cited as an authority for the proposition that the court preferred a claim arising eleven months prior

to the appointment of the receivers. In that case it appears that the latter took office on January 2, 1875. The claim was for coal furnished to the company "during the year 1874, but the precise time in the year is not given" (bottom page 777, top page 778). There is nothing in the statement of facts or the opinion of the court to show that the coal was delivered more than six months before the appointment of the receiver, and not a word in the opinion of the court concerning the six months' rule. The case, therefore, is nugatory, so far as this question is concerned.

The same may be said with respect to *Central Trust Co. v. Wabash R. R. Co.,* 30 Fed., 332. Although particular reference is made by the appellants to page 334 of this report, there is not a word on that page concerning the six months' rule, nor, in fact, is there any discussion of that rule in the entire opinion of the court. In fact it is not stated therein when the preferential claims there under discussion accrued. The whole question before the court was as to the fairness of the apportionment of earnings among different divisions of a large railroad system. The case does not even bear a resemblance to the point under discussion.

Farmers Loan and Trust Co. v. Kansas City Co., 53 Fed., 182, is also strongly relied upon by the appellants to sustain their contention that there is no six months' rule. That was a decision by Circuit Judge Caldwell of Kansas in 1892. There the court made a general order requiring as a condition of the appointment of the receiver that the plaintiff should consent,

upon the record, that *all* debts for repair and materials, contracted since the date of making the mortgage, be paid out of the proceeds of the foreclosure sale, if not sooner paid out of the earnings of the road. After being particularly advised of the terms of this order, the plaintiff Trust Company instructed its counsel to assent to the condition and the receiver was thereupon appointed expressly *upon* such condition. Thereafter certain bondholders on their own application, petitioned to become parties defendant and moved to strike from the decree that part of the order awarding priority to the claims in question. The court held that the appointment of the receiver was not a matter of right, but rested in the sound discretion of the court, that the latter in appointing such receiver might impose such conditions as appeared to be just and equitable, and that the parties asking for and accepting the appointment of the receiver upon such conditions will be bound thereby; and further that since a trustee in a railroad mortgage foreclosure represents the bondholders, whenever such trustee in good faith assents to terms imposed by the court as a condition for appointing the receiver, the bondholders are bound by such assent as fully and absolutely as if it had been given by them in person (id., 185).

Inasmuch as the objecting bondholders did not allege any fraud or bad faith on the part of the trustee (id., 186), Judge Caldwell could, and we respectfully submit should, have stopped at this point in his decision. Nevertheless, he proceeded to expound, at considerable length, his general ideas on the subject of

preferential debts of railroads, and although this part of his opinion is interesting, it is nothing more than pure dictum. Among other things he holds that a diversion of income is not essential to give these debts priority (id., 189). In this respect he must be deemed to have been overruled by the Supreme Court of the United States in the Gregg case. Judge McKenna in his dissenting opinion mentions the Farmers Loan & Trust case as being contra to the majority opinion of the Supreme Court in the Gregg case on the point of there being no necessity of diversion of income. Furthermore, even Judge McKenna in his dissenting opinion, in the Gregg case, holds, with respect to the rule of preference, as follows:

> "It cannot be confined to debts contracted during the receivership. It may extend to debts contracted before the appointment of the receiver. But recognizing that there must be some limitation of time, *the courts have fixed six months as the period within which preferential claims may accrue.*" (Italics ours.)
>
> 197 U. S., 196.

Again the Farmers Loan and Trust Company case was decided in the Eighth Circuit, and appellants, counsel himself admits in his brief, at page 33, that the courts in that circuit are bound by the six months' limitation.

Hale v. Frost, 99 U. S., 389, is also cited by the appellants as an authority upon this point. That case was decided immediately after the case of *Fosdick v. Schall,* in 1878, which was practically the year of the

birth of the preferential claim doctrine, and before the Supreme Court or the various Circuits Courts had had an opportunity to develop its limitations. There is no discussion in the Hale case of the question of time.

Appellants also cite *Southern Railway Company v. Carnegie Steel Company,* 176 U. S., 257, as an authority upon this proposition, but there the court held with respect to the six months' rule, at page 292, that:

> "Such a rule will do full justice in most cases to creditors who are entitled to look to current receipts for the payment of current debts."

The court then proceeded to cite with approval the language of Mr. Justice Brewer in *Blair v. St. Louis R. R. Co.,* 22 Fed., 471, at p. 474, touching this question of time and the principles upon which the equitable rights of creditors in such cases rests, as follows:

> "The idea which underlies them I take to be this: That the management of a large business, like that of a railroad company, cannot be conducted on a cash basis. Temporary credit, in the nature of things, is indispensable. Its employes cannot be paid every month. It cannot settle with other roads, its traffic balances at the close of every day. Time to adjust and settle these various matters is indispensable. Because, in the nature of things, this is so, such temporary credits must be taken as assented to by the mortgagees. * * * In this view, such temporary credits accruing prior to the appointment of the receiver must be recognized by the mortgagees and such claims preferred. Now, for what time prior to the appointment of a receiver may these credits be sustained? There is

> no arbitrary time prescribed, and it should be only such reasonable time as, in the nature of things and in the ordinary course of business, would be sufficient to have such claims settled and paid. *Six months is the longest time I have noticed as yet given. Ordinarily, I think that is ample.* Perhaps, in some large concerns, with extensive lines of road and a complicated business, a longer time might be necessary" (pp. 292, 293). (Italics ours.)

In *Southern Railway Co. vs. Carnegie Steel Company* case the mileage was enormous, since the Danville Company possessed and controlled, in addition to its own line, more than twenty other railways, and its business was, necessarily, tremendously complicated.

We are confident that after an examination of all the cases cited on this point, not only by us, but also by the appellants, this Court will find the true rule to be as stated by Judge Dietrich in his opinion in the Court below, where he holds as follows (Transcript 136):

> "Generally, too, the application of the principle is limited to labor and supplies furnished within the period of six months immediately prior to the institution of the receivership. In a sense doubtless the limitation is arbitrary, but nevertheless it has come to prevail as a general rule. *Spencer vs. Taylor Creek Ditch Company*, 194 Fed., 635. * * * True, the time limit is not always observed, and instances may be cited where claims of much longer standing have been recognized, but if a rule at all, it must control in all cases which are not substantially exceptional. The discretion to

relax it is a judicial discretion, resting upon something more substantial than mere whim or caprice" (Transcript 137).

What special circumstances or facts do the appellants urge in order to induce this Court to relax the general rule and to "extend a limit imposed in the sound discretion of the Circuit Court" (*Central Trust Co. v. E. Tenn. V. and G. R. Co.,* 80 Fed., 624, at 630)?

So far as we can judge from the appellants opening brief (pp. 30 and 31), they base their claim to special equities upon the following alleged facts:

> "Stated more clearly, the manager of the bondholding syndicate who was also the Vice-President and Managing Director of the Railway Company, himself was responsible for the purchase of the material, which was to be paid for out of the earnings, and almost immediately thereafter diverted the earnings to the payment of the interest on his own bonds; and a few weeks over six months thereafter, joined in the petition for the appointment of the receiver. Among all the cases upon this subject we think none will be found in which the creditor has been denied payment, and the bondholder permitted to retain the benefit, where all of the elements of preferential claims above outlined have been present."

Now let us examine the record for the purpose of testing whether or not the above is a fair statement of the facts as proved in this case.

It is, of course, true that Mr. Fuller was Vice-President of the Railway Company. It is only *par-*

tially correct to say that he was "managing director of the railway company." The testimony on that point was as follows:

> "Samuel L. Fuller is the Vice-President of the Railway Company, and with respect to finances, he was in fact its managing director, *but not in respect to the technical or the detailed management of its affairs; I had charge of that*" (Tr. 118).

It is to be noted that the witness was Mr. Markhus, who prior to his appointment as receiver, was himself *general* manager of the company.

The next statement is that Mr. Fuller *"himself* was responsible for the purchase of the material, which was to be paid for out of the earnings." There is no proof of that fact in the record. The only testimony on this point—which, by the way, relates solely to the Roebling claim—is the following by Mr. Markhus:

> "The order was placed *here. I don't recall who* instructed me to give the order, but we got instructions from New York. *Someone* advised us of the necessity of building that line in order to fill those power requirements of the Gem District" (Tr. 118).

Far from stating that *Mr. Fuller* "was responsible for the purchase of the material" the witness testified that the order was placed by the *local* management and that he did not recall *who* instructed him to give the order. The further statement "but we got instructions from New York" is of absolutely no probative value on this point, since he did not state *what*

were his instructions or *who* gave them.

So far as the I. P. Morris claim is concerned, there is not even a *pretence* of any proof that Mr. Fuller was responsible for the purchase of the material.

With regard to the further statement that the material "was to be paid for out of the earnings" we have already pointed out that there is no proof in the stipulation of facts or elsewhere in the record that it was the intention of the *Railway Company* that these materials should be paid for out of earnings, and so far as the I. P. Morris claim is concerned, the stipulation of the facts with respect to the belief and intention of that company was merely that the materials would be paid for out of current income, "unless *otherwise* provided for by the Railway Company" (Tr. 73).

But even assuming that Mr. Fuller *was* responsible for the purchase of the material, not only from the Roebling Company but also from the I. P. Morris Company, in what respect does that add to the claimants' equity? Of what importance is the fact that Mr. Fuller was also the manager of a syndicate composed of fifty or one hundred different bondholders, scattered all the way from Montana to New England (Tr. 128)? The appellants in their brief (p. 70) expressly concede that Mr. Fuller's connection with the company and the syndicate constitutes no estoppel, "nor is it intended *as a charge of bad faith or fraud.*" Therefore, assuming merely for the purposes of argument, that Mr. Fuller *was* responsible for the purchase of the material, acting without fraud, and in

all good faith, as this Court is bound to presume in view of the record and of the appellants' concession—how does this fact serve to invest the appellants' claims with any peculiar or extraordinary equity?

There is no proof that Mr. Fuller or any other member of the syndicate directed the railroad company to *withhold* payment of these claims so that the bond interest, due on June 1, might be paid.

There is not the slightest suggestion in the record that at the time, June 1, 1913, when this interest payment was made, Mr. Fuller or anyone else anticipated the appointment of a receiver.

On the contrary, the record shows that as late as May, 1913, *Kissel, Kinnicutt and Company, Mr. Fuller's own firm, was willing to, and did loan the company* $30,000 *merely on its note* (Tr. 43).

If Mr. Fuller was, at the time, cunningly contriving to divert the current income of the company to the payment of bond interest at the expense of the claimants and with a view to the possible insolvency of the company, it seems most extraordinary that he should have been so foolish, at the very same time, as to sink $30,000 of his own money or that of his firm, into this very same enterprise whose imminent failure the appellants intimate, but do not openly charge, he then had in mind.

The entire basis upon which the claimants seek to predicate an extraordinary or special equity is so flimsy as to hardly justify further argument. We can do no better than to quote from the language of Judge Dietrich on this point:

"What reason can be assigned for treating the instant claim as an exception? It is a just debt and should be paid. But that is an appeal which any creditor of any insolvent debtor can make. The claimant expected to be promptly paid in the ordinary course of business, but such is the usual expectation. *There were no misrepresentations, no deceitful promises, by which it was induced to remain inactive. Upon the whole, the case is one of ordinary commercial credit, typical, rather than exceptional*" (Transcript 137).

And again at page 139:

"Effort was made to show that the relation of the bondholders to the Railway Company was such as to estop the trustee from denying the intervener's equity, but the evidence will not support a finding of that character. Essential elements of estoppel are wanting" (Transcript 139, 140).

It is the practice of those who desire to be considered preferential claimants to dilate upon the unfortunate situation of the material and supply creditor and upon that basis to appeal to the sympathy of the Court. But what about the situation of the bondholders? If this Court should reverse the decision of the court below and grant to these claimants a preference over the mortgage bondholders, it will, we respectfully submit, extend the doctrine of equitable preferences to new fields, and its decision will become a new landmark in the law with respect to the rights of railroad bondholders. As a rule the holders of such bonds, are small investors scattered throughout the country, who generally pay one hundred cents

on the dollar for their securities, and who are dependent upon the small income derived therefrom, in the hope and belief that their principal, at least, is secure. If the railroad company fails and its properties are sold under foreclosure for less than the amount of the mortgage bonds, the loss under such circumstances to the bondholders is particularly severe. In the case at bar the bondholders only got back about 53 cents on the dollar. On the other hand, the material and supply creditors, are generally firms or corporations actively engaged in furnishing merchandise to railroad corporations, amply equipped with the means of acquiring credit information and willing to take a business risk in extending credit, in exchange for which they expect, and receive, a very substantial profit. The face amounts of their claims, therefore, do not by any means represent, as is generally the case with the bondholders, a complete out-of-pocket loss.

Every decision, therefore, that extends to new limits the doctrine of equitable preference of material and supply claims over those of bondholders, mitigates against the security of such bonds for investment purposes, and renders increasingly difficult that financing of new railroad construction, which is so essential to the proper development of this country, and particularly the Western portion thereof.

We, therefore, repeat that unless this Court can find in the record before it some special or extraordinary circumstances justifying the relaxation of the customary rule, which was expressly adopted in this

Circuit, and by this Court in the case of Spencer vs. Taylor Creek Ditch Company (supra) and which limited preferences, to such claims as have accrued within six months prior to the appointment of the receiver, it should, on this point alone, affirm the decree of Judge Dietrich.

Recapitulation.

We contend that the claim of preference of John A. Roebling's Sons Company should be disallowed for the following reasons:

First: Because the material which formed the consideration of the claim was, with the knowledge of the claimant, devoted to new construction, permanent additions to and extraordinary improvements in the property of the defendant company or that of the Idaho Oregon Company, and, therefore, this claim cannot properly be characterized as a current operating expense contracted in the ordinary course of business.

Second: Because this claimant has utterly failed to show a diversion by the Railway Company of any income earned ~~prior~~ subsequent to the accrual of the claimant's debt, but, on the contrary, the record shows that the monies from which the payment of June 1, 1913, was made were derived by the company from the sale of bonds and earnings made by it prior to the accrual of such debt.

Third: Because the appellants' claim concededly did not accrue within six months prior to the appointment of the Receiver and the record is barren of any

special or extraordinary equities in its favor, justifying a departure from the general rule which was applied by the Court below in the exercise of its sound discretion.

We contend that the claim of preference of I. P. Morris Company should be disallowed for the following reasons:

First: Because the consideration of this claim consisted in important power-generating machinery, of great value, which now represents approximately 60 per cent. of the total power generated by the plant in which it was installed, and, therefore, constituted new construction work and a permanent addition and extraordinary improvement to the mortgaged property, and cannot properly be characterized as a current operating expense incurred in the ordinary course of business of the defendant company.

Second: Because, if the claim be deemed to have accrued within six months prior to the appointment of the Receiver, there could have been no diversion of income as to such claim, since the payment of June 1st, 1913, made nearly *seven* months before the appointment of a Receiver, is the sole basis upon which the appellants seek to predicate such a diversion.

Third: Because, if this claimant contends that its claim did *not* accrue within six months prior to the appointment of a Receiver, it is debarred by the six months' rule and there are no special or extraordinary equities in its favor, justifying a departure from the general rule which was applied by the Court below in the exercise of its sound discretion.

For the above reasons, these appellees pray that the decree of the Court below be in all respects affirmed.

Respectfully submitted,

JOHN F. MACLANE,

Attorney and Solicitor for Idaho Railway Light and Power Company, O. G. F. Markhus, Receiver of said company; Guaranty Trust Company, Trustee, and Electric Investment Company.

HENRY ROOT STERN,

Of Counsel.